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COMMENT AND OPINION

The Public Accountancy Act of Ontario

THE enactment by the Province of Ontario of an Act to regulate the practice of public accountancy in the Province is of major interest to the profession. The Act itself is reproduced in full at p. 233. This legislation follows the pattern of the bill under consideration in the United Kingdom. It requires that all public accounting practitioners must have a licence after August 1st next and provides for the constitution of a Council made up of practising accountants for its administration. The terms "public accountancy" and "public accountant" are defined. Persons engaged in bookkeeping, cost accounting, or the installation of bookkeeping, business and cost systems, are not required to have licences. It is also not necessary for employees of licensed practitioners and the auditors of certain public bodies and banks, loan, trust, or transportation companies to obtain licences.

Recognition is given to The Institute of Chartered Accountants of Ontario and The Certified Public Accountants Association of Ontario as qualifying bodies, and those persons who are on the membership rolls at August 1, 1950 are eligible to obtain licences at any time. Persons who become members after August 1, 1950, must have taken the regular courses and passed the final examination of their association to be eligible. All other public accountants who have been in practice for one year before the licensing date may apply for a licence. Provision is made for granting licences in the future to applicants who have passed an examination deemed to be equivalent to the intermediate examination of either of the qualifying bodies and have practised or have been employed in public accountancy in Ontario for three years. Provision is also made for granting licences to applicants from States or Provinces other than Ontario.

A person who has been licensed is entitled to a renewal of his licence but the Council has power to revoke a licence where the licensee has been found guilty of conduct disgraceful to him as a public accountant and under certain other conditions set out in the Act.

A fee will be payable for the granting or renewal of a licence not to exceed $25. The amount of the fee will be set by the Council after it is organized.

The Effect of Tax Legislation On Conventional Accounting Practices

MORE strongly than ever, we hold the view that, when the effects of provisions of income tax legislation are to distort accounts of enterprises, we should raise objection and remind all concerned that the functions of a taxing statute are to measure the prop-

erty that is subject to tax and to impose a tax to the appropriate extent of the measurement. If the taxing statute goes further and provides that accounts which would ordinarily be drawn up in accordance with conventional accounting principles must be slanted one way or another we should all take strenuous objection.

It is with some surprise, therefore, that we see *The Financial Post* on page 9 of its issue of April 1, 1950 discussing the budget resolution dealing with the proposed 15% tax on undistributed income of private companies and making the comment on the tax-paid part of this undistributed income, "How [the company] will show this in its balance sheet is one point which will have to be cleared up by the legislation".

What has an Income Tax Act got to do with how a company shows anything in its annual accounts? And why should a treatment for tax purposes alter the facts or the results of a series of transactions?

Why should depreciation and tax-free surplus be singled out for special consideration? We have not heard that dividends received by a corporation should be excluded from the income account because they are not subject to tax in the hands of the receiving company; neither have we heard that disbursements not deductible for tax calculations should be excluded from the income account.

It is the transaction itself that either sets up or reduces a tax liability. The conventional accounting technique of recording a transaction which is subject to special taxation or exemption from tax cannot affect the ultimate liability to tax and tax legislation should not twist conventional accounting techniques to suit its own purpose.

Words and More Words

MUCH has been written and said of the desires of writers to make a simple statement more profound by using long words and unfamiliar phrases. Most of the complaints have been directed against government officers and pronouncements, but now we have an opportunity to criticize free enterprise for the same fault.

We have been reading a large number of annual reports of corporations, both the narrative and the financial statements. It seems to us that the narrative parts of them are getting longer and longer, and are more and more interrupted by charts, pies, statistical tables, drawings and photographs. We wish now that someone would prepare a synopsis which could be sent to shareholders, employees, and to all others except, perhaps, economists. The things are becoming too beautiful and too unwieldy; we want to look at and admire the product rather than the state of the affairs of the reporting company.

What started this note was a sentence in the 1949 report of a large United States corporation.

> A much improved liquid position was achieved primarily through adding to retained profits funds made available by the reduction of inventories.

This company could have said with equal justification that a reasonable part of the improved liquid position was achieved through adding to retained profits funds made available by the reduction in its accounts and notes receivable. Perhaps public accountants should be permitted to review these reports of management in the hope that they would emerge in more concise and readily understandable form, by the use of more precise and readily understandable language.

Public Moneys

By Montagu Clements, C.A., A.C.I.S.

A review of financial reports on the funds of sovereign states

Purpose of the Accounts and Financial Reports

"YOUR statement, Mr. Clements, reminds me of a clock which is owned by one of my friends. He tells me that when the hands point to twenty minutes to twelve, and it strikes nine, he knows that it is a quarter past two."

This remark hurt my feelings. It also taught me that it would be to my advantage to prepare statements in a form and language understood by my clients.

The accounts of a State are set up for the purpose of controlling collections and expenditures of public moneys. They must also provide information from which periodical financial statements can be prepared.

Incidence of the Consolidated Revenue Fund

Prior to 1787 a practice existed in Great Britain whereby the various taxes and the other revenues from different sources were held in separate funds with the object of applying revenues from one source to the particular class of expenditures to which they had been allocated. Some of the British colonies adopted the consolidated fund idea. A study of the results has led to the conclusion that the constituent parts of the fund varied in different provinces and countries. Canada seemed to put all public moneys into its consolidated revenue fund, and according to the *Consolidated Revenue and Audit Act* public moneys included borrowings and trust funds. Ontario put in all special funds and all public moneys and revenues. Natal formed a consolidated revenue fund and also a consolidated loan fund: from the latter it appropriated amounts for what would usually be called capital expenditures. Saskatchewan put its revenue earnings and the proceeds of its borrowings into "one *consolidated* fund" which did not include trust funds. Thus it refused to perpetuate any unorthodox terminology which would seem to list loan funds and trust funds among the component parts of a *revenue* fund.

It has been difficult to discover the origin of the idea of calling the consolidated fund a "revenue fund". Did it start with Canada or Ontario or did both copy another State? The important fact is that the consolidation of all funds representing public moneys has been regarded as a necessary step towards the securing of parliamentary control over the resources of the Crown: "not the control of Parliament in its constitutional sense as composed of Sovereign, Lords,

and Commons, but control by the Commons alone" (see "The Principles and Practice of the System of Control over Parliamentary Grants", by Col. A. J. V. Durrell, C.B.)

Accounting Structure

The structure of the accounts of a governmental body should be designed so that the necessary financial statements can be prepared in a form which will not only disclose the situation as of a certain date but also the operations of the funds in which the State has an interest — the figures indicating the accumulation and expenditures of public moneys and trust funds during each fiscal period. In the event of the operations of the current revenue fund resulting in a deficit, the accounting system may also need to provide information which will disclose the plan by which this deficit has been, or will be, liquidated.

Segregation of the Accounts

Many governments have adopted a standard practice successfully used by certain large financial corporations as a means of recording the financial picture of the funds under their supervision and control. It is used by some of the provinces of Canada and by other governmental bodies although the terminology is not always uniform. Capital funds may be referred to (as in the case of the colony of Natal previously mentioned) as loan funds. The account of the revenue funds — those expendable funds which arise from the creation and realization of revenues — may sometimes be described as the income account. According to a standard work on governmental accounting[1] "the term 'revenue' is synonymous with 'income' in governmental accounting, except in publicly-owned utilities. In these enterprises, following the usage applied in privately operated undertakings of a similar nature, the term revenue is applied to operations only, and the term income is used to cover all revenues."

[1] "Fundamentals of Governmental Accounting", by Morey and Hackett

A Modern Balance Sheet

The balance sheet issued by the Province of Alberta provides a useful illustration of the application of modern practices in the field of governmental accounting. The accounting structure used reflects the influence of Mr. James C. Thompson, F.C.A., who needs no introduction to many readers of *The Canadian Chartered Accountant* and whose outstanding ability has been recognized by the members of the Rowell-Sirois Commission and others who have been fortunate enough to have Mr. Thompson's co-operation and advice on their financial and accounting problems.

The balance sheet above referred to gives clear and concise information regarding the capital, income, and trust funds controlled by the Government of the Province of Alberta. (The word "income" is used here as it is the term used instead of "revenue" in the accounts under review.) In its general plan, the balance sheet presents each fund consolidation in an overall picture that needs no adjustments or computations by the reader before he can understand the implications of this summary of the financial operations of the Government. "Indirect liabilities", shown as an appendix, would become a charge against the income fund, only in the case of failure of one or more of the debtors involved.

From the "capital" subdivision of the Alberta balance sheet it may be noted that this class of expenditure is financed from loan funds, some of the money having been borrowed from income account surplus.

Trust funds, quite obviously, form no part of either capital or income funds although there may be interfund transactions between the accounts to cover such items as borrowings and transfers by agreement. Following the regular practice adopted by corporations which handle trust funds, the total value of the trust assets is offset by a corresponding liability of the trustee.

The public interest in the capital assets accumulated by the government and the method by which these have been financed is relatively small, but the "capital" subdivision may be of valuable assistance to the auditor in his task of verifying the accuracy and authenticity of capital expenditures. Nor would the "trusts" subdivision of the balance sheet excite the popular interest generally unless perhaps there was a suggestion in the auditor's certificate that trusts were not being properly administered. It is the "income" subdivision which shows the soundness or otherwise of the government's financial health. Some of the leading questions which may be asked are: "Did revenues cover expenditures last year?" "How do the results compare with those of previous years?" "What is the present position of the revenue fund?". The public should have a direct answer to these questions and the "income" subdivision of the balance sheet can give the clear and concise answer required if its accounts have been isolated from those which only concern the capital and trust accounts. The key figures are those which tell of the expendable surplus or deficit of the income fund together with funded revenue deficits if it has been necessary to resort to this expedient at any time. (The matter of revenue deficits is given special consideration in the next section of this paper.) It will also be evident that, in order to answer the questions set out above, the result of each year's operation of the income fund must be separately indicated.

Mr. Montagu Clements, C.A., A.C.I.S. received his education and early experience in England and came to Canada in 1910. In 1921 he was admitted to the Saskatchewan Institute and practised his profession in that Province for a number of years. He joined the staff of the Auditor General of Canada in 1934 and was superannuated in April 1950.

Saskatchewan's Balance Sheet

The Alberta accounts have been used for purposes of illustration because they were found to be the most suitable among the particular accounts examined. There is no intention to imply that other Provinces publish their balance sheets in unsatisfactory form. The balance sheet of Saskatchewan follows the same general lay-out as that of Alberta, but puts in an extra subdivision which will be referred to later. It divides its consolidated fund into its two natural component parts by placing its capital and revenue accounts in their respective subdivisions, each of the subdivisions being self-balancing. Thus the balance sheet as a whole follows the general design of that published by the Province of Alberta and those issued by many trust companies and financial corporations engaged in the operation and control of capital, revenue, and trust funds.

Manitoba's Balance Sheet

Manitoba carries the conventional "capital" and "trusts" subdivisions and places the rest of the accounts under "current" and "deferred". The surplus indicated in the "current" account seems to represent the surplus of the revenue fund; the "deferred" account assets are chiefly unsold lands, the indicated value

of which has not been included in the surplus of the subdivision — a commendable procedure. The introduction or otherwise of natural resources into the balance sheet involves a detailed discussion of capital assets which has no place in this article. The need to be emphasized is a clear picture of the revenue account, not forgetting the current revenue account. This is also of paramount importance in the accounts of a private enterprise. If you care to refresh your memory on the developments in the celebrated R.M.S.P. case (see *The Canadian Chartered Accountant,* Vol. XXI), you will note that all the trouble arose through failure to recognize the fact that a current revenue account presented for public scrutiny should be credited, *in a manner which the public can clearly understand,* with the current revenue, the whole current revenue, and nothing but the current revenue, so help me . . . !

Apparently, the publication of the company's revenue statements in the form adopted was to help the flotation of a new issue of share capital — the statement was to be used as a means of support rather than for purposes of illumination, as a drunkard may sometimes use a lamp post.

Revenue Fund Deficits

There does not appear in the balance sheets examined for the purpose of this article any clear record of revenue deficits funded. Canada shows a "consolidated deficit" which represents the net debt of Canada less its "non-active assets". Alberta shows a substantial surplus in income account. Some of this has been loaned to capital fund and in this manner has effected a saving in interest expense. In recent years Saskatchewan has carried a special subdivision called "relief account". This subdivision has no doubt given additional information to many who use the balance sheet. To the person, however, who looks to the revenue account subdivision for information regarding the condition of the revenue fund, the news of what seems to be a revenue fund deficit has been concealed and might be missed altogether if his eye did not stray on to the "relief account" and finally lead him to the conclusion that a deficit rightly belonging to the revenue account had been funded by a loan from capital funds. Much of this loan has now been paid and it looks as if Saskatchewan will shortly be able to revert to the orthodox balance sheet with three subdivisions, and its "capital account" subdivision will no longer show assets resulting from expenditures which in order to be classed as "capital" should, according to Geo. O. May, arise from expenditures, "the usefulness of which is expected to extend over several accounting periods" (see *The Canadian Chartered Accountant,* Vol. XXXIII).

Although the above illustration may suggest a rather vague way of admitting a revenue fund deficit, there is no law as to how these deficits must be indicated. Sometimes the revenue fund budget may be upset by an emergency (or through some other cause) so that current revenues have been unable to take care of all expenditures. In order to take the deficit out of the current revenue account so that future revenues may still be available to take care of the expenditures for which they are raised, the deficit is sometimes funded by raising a long term loan to be paid from the revenues of future fiscal periods. The appearance on the balance sheet of "funded revenue deficits" (when such exist) tells the public that expenditures payable from the revenue fund have been at some time in excess of current revenue earnings and the gap has to be closed. The deficit may be liquidated by regular payments (into a sinking fund, if this plan is used) from the revenue funds of a speci-

fic or indefinite number of future fiscal periods.

In the balance sheets of national governments the revenue account deficits and the plans for their adjustment are not usually obvious, and the exact state of the revenue fund may be confused by including, along with the revenue account data, figures relating to fixed items and other unrelated assets and liabilities; the confusion may be increased by the use of terms not readily understood by the public. In the days of not so long ago, Dean Swift is said to have complained of the obscurity of certain words and phrases used by officialdom and drawn a retort from Lord Chesterfield that "precision and perspicuity were not, in general, the favourite objects of Ministers".

This calls to mind another old time story about a king's jester who defended himself successfully by finding an excuse more outrageous than his offence.

Advantages of Segregation

Looking over the balance sheets of various States and Provinces, it is not difficult to note the improvement effected by segregating the fixed items in a self-balancing set of accounts. Unlike the fixed assets of an industrial corporation, those owned by a government may not generally be regarded as security for financial obligations and, for this reason, are not a basis for credit. The current valuation of the fixed assets of a State is therefore not important. These assets may have been acquired by purchase or gift often as the result of revenue fund expenditures or from the proceeds of special loan funds. The government is responsible for the property and it should therefore be shown in the balance sheet along with any associated long term liabilities to be paid out of resources yet to be realized. The accounts of fixed property resulting from the expenditures above referred to, however, have nothing to do with current assets, current liabilities or operations and have no place in the revenue account.

A simple example of the segregation of fixed assets can be seen in the balance sheet of the Yukon Territory. Under the heading of "capital account", public buildings, furnishings and road equipment are indicated. The total valuation placed on these appears as "capital surplus".

It would seem that if precision and perspicuity are to be the objects of the minister responsible for the publication of the financial statements of the government, the achievement of his aim could be assisted by segregating the fixed items referred to, so that the revenue account would reflect the information expected from it without obstruction or interruption from extraneous information.

The LIFO Method Of Inventory Valuation

By R. MacDonald Parkinson, M.B.E., C.A.

A justification of LIFO as a sound basis of inventory valuation and an answer to its antagonists

THE words "last-in, first-out" are used accounting-wise in connection with trading operations to describe the flow of costs or cost factors, and are not used in the sense that the specific items in an inventory, whether identified or not, are flowing on a last-in, first-out physical basis. The LIFO method or technique of inventory valuation is based upon a study of cost factors and upon the theory that a proper recognition of the flow of these cost factors may be essential for the preparation of accurate statements of periodic income.

Why Financial Statements?

The duties of an accountant would be extremely simple if there was no requirement to prepare financial statements except at the end of the life of an enterprise; it is only at this point of time that the total profits which have been earned over its life can be finally determined without the necessity of using estimates or introducing assumptions and approximations. However, a company must have some guide from time to time as to how it is doing, and it is obviously impossible to wait until the enterprise is wound up. For purely arbitrary reasons the life of each business is divided into 12-month periods and accurate annual financial statements must be prepared. The profit and loss statement is like a motion picture showing what has happened or what was done during the past 12 months, while the balance sheet is like a snapshot at one instant of time showing how the enterprise stands. Both of these statements are based on assumptions and probabilities and it is the aim of accountants, whether in business or practice, to make the best possible estimate of the correct figures if the statements are to be useful.

The value of an inventory appears on the balance sheet and the *amount* of this inventory is deducted from costs in determining the profit or loss for the period. This point, that the *amount* of the inventory affects two statements, is very important, and even though in some instances the objectives of the balance sheet conflict with the objectives of the profit and loss statement, only one calculation of value can be admitted if our financial statements are to be in balance. The problem of selecting appropriate methods of inventory valuation comes down to the question of whether inventories are valued primarily for the purpose of ascertaining the amount of a company's in-

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vestment in the inventory, or for the purpose of calculating the amount of profit made during the period.

Emphasis on the Profit Statement

For many reasons, such as the development of large scale manufacturing, the formation of stock exchanges, the introduction of small investors in corporate enterprises, heavy taxation, and the trend toward labour-management partnerships, the atmosphere in which business operates has changed, so that at the present time more and more emphasis has been placed on the necessity of obtaining a more accurate measure of periodic income in the profit and loss statement. With the ever increasing importance of this statement, the purpose of which is to divide profits over the entire life of a business into annual increments, it follows that inventories should be valued in such a way as to make possible a truly accurate measure of earnings for each period, regardless of the implications arising out of the balance sheet valuation. The committee on Accounting Procedure of the American Institute of Accountants phrases the theory this way — "A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues", and it goes on to state that "the inventory at any given date is, in effect, a *residual amount* remaining after the matching of absorbed costs with concurrent revenues". The carrying value of this residual amount is somewhat like that of a fixed asset in that it need bear no direct relationship to current value and might be either more or less than replacement cost or realizable value; it is a cost which is deferred against future periods.

What Is "Cost" and "Market"?

It is generally agreed that inventories should be valued on the basis of cost or market. This general statement is good as far as it goes, but it leaves unsaid far more than it says, because the real difficulty is to decide what is cost and what is market. For example, what is meant by "market"? Is it replacement cost by purchase or manufacture, or selling price less costs of selling, or selling price less costs of selling and less normal profit margin? The term "cost" is even more elusive. Is the cost of raw materials the invoice cost or the delivered cost? What should be done with double freight and rehandling expense? Should the profit on inter-company transactions be eliminated? A current topic concerns the accounting treatment for foreign exchange in a time of fluctuating currencies. In the case of partly processed and manufactured goods the problems are even more obscure — should standard costs be used, what should be done with over-absorbed or under-absorbed burden, what is the effect on valuation arising out of idle facility expense, double shift operations, etc? Happily, the subject under discussion is the LIFO method *in principle* rather than *in detail,* and therefore we need not be concerned with the answers to the above questions, and I have mentioned them only for the purpose of illustrating the numerous methods or mechanics from which to select a detailed method for determining that cost or market which will most clearly reflect periodic income.

Physical Identification of Items

One difficulty of determining cost which I did not mention concerns the question of whether the value of an item in the inventory need necessarily be related to the specific physical identity of the item. For example, let us suppose a seller has two pencils identical in every way except that they were purchased a few days apart, and in that few days there was a price change. One pencil has been sold and one remains in the inventory; the question is whether the

amount of profit earned is *necessarily* related to the specific physical identity of the pencil which remains in the inventory. In other words, should the seller's profit differ because of the physical identity of the pencil which he delivered on the sale? It is the failure to agree upon this point which is responsible for much of the controversy which you may have heard in connection with the LIFO method.

The advocates of LIFO insist that methods based upon physical identification of goods in inventory are not necessarily accurate for the determination of income. Recently Maurice Peloubet, who has held numerous high offices in the American Institute of Accountants, addressing a special meeting of the Ontario Institute of Chartered Accountants, compared two businesses which had opposing flows of physical goods in circumstances where the costs should be identical. Mr. Peloubet said—

> For a clear, but perhaps somewhat exaggerated example, you might consider two foundries. Any foundry uses a large amount of coal. Foundry "A" receives its coal from a railway siding on level ground and removes the coal from the cars by a crane which piles the coal in a storage yard of the foundry. The same crane subsequently picks up the coal and delivers it to the point of consumption. Foundry "B" is built in somewhat different country. The foundry is situated under the brow of a steep bluff or cliff. The railway runs along the top of the cliff. The foundry has constructed several concrete bins, not unlike very large silos, to receive the coal as it is dumped from the cars. It falls into the silos and is removed from them by opening doors in the floor, allowing the coal to fall into the trucks by gravity, the trucks delivering the coal to the productive units of the foundry . . . . Would anyone say that the two foundries, carrying on a substantially similar business, should cost their coal into production on different bases and carry their inventory at different values? I can hardly believe that any intelligent business man or any advisor to a business man, legal, engineering or accounting, would take such a position. It does not require much analysis to see the essential invalidity of any argument for or against an inventory method based *entirely* or *principally* on physical movement.

With certain minor exceptions, therefore, we might conclude that the *physical* identification of the items in an inventory is unimportant. Exceptions include such items as gems, antiques, pictures, rare books, musical instruments and goods having a style value, and in other instances where the value, even though not a high one, is related directly to the specific article.

What Standard Then?

If the physical identity is unimportant and if we cannot rely on physical movement as a guide, by what standards can we establish value in an inventory? I will go back to my earlier quotation from the American Institute of Accountants, which defined an inventory value as being the *residual amount* remaining after the matching of *absorbed costs* with concurrent *revenues*. These words contain the key to the answer. By using the word "absorbed" it is indicated that operations must be charged with those costs which relate to the sales, regardless of whether or not they were incurred during the period, and costs incurred in the period, which would include the opening inventory, and which do not apply to the "concurrent revenues", are to be carried forward in the closing inventory.

In most business operations it would be a tremendous, if not impossible, task to maintain the records that would be required to identify the specific cost relating to each sale. In order to avoid this task, accountants have introduced the technique of studying the relationship between costs and sales with a view to de-

termining what is called "the flow of costs" or "cost factors". In making this study many factors which have little to do with bookkeeping must be taken into account — the business practices of the industry and the particular company, management policy, the manufacturing operation, and the like.

Again reverting to the pronouncements of the American Institute of Accountants, I quote from Statement 4 of Accounting Research Bulletin No. 29, which was issued in July 1947. I could not hope to improve upon the clarity of this statement.

> Statement 4 — Cost, for inventory purposes, may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out, average, and last-in, first-out); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income.
>
> *Discussion*: The cost to be matched against revenue from a sale may not be the identified cost of the specific item which is sold, especially in any cases in which similar goods are purchased at different times and at different prices. Ordinarily, under those circumstances, the identity of goods is lost between the time of acquisition and the time of sale. In any event, if the materials purchased in various lots are identical and interchangeable, the use of identified cost of the various lots may not produce the most useful financial statements. This fact has resulted in the development and general acceptance of several assumptions with respect to the flow of cost factors to provide practical bases for the measurement of periodic income. These methods recognize the variations which exist in the relationships of cost to sales prices under different economic conditions. Thus, where sales prices are promptly influenced by changes in reproductive costs, an assumption of the LIFO flow of cost factors may be the more appropriate. Where no such cost-price relationship exists, the first-in, first-out, or an average method, may be more properly utilized . . . In some cases, the business operations may be such as to make it desirable to apply *one* of the acceptable methods of determining cost to one portion of the inventory, or components thereof, and *another* of the acceptable methods to other portions of the inventory . . . .

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Flow of Cost Factors

In normal times competition, together with buyer resistance, is probably the largest single factor in establishing prices. As a consequence, most sellers are forced to liquidate inventories of goods on hand at the time of an increase in replacement cost, at the former selling prices; and increased selling prices are introduced only with respect to those goods purchased at increased costs. In these circumstances there is a direct relationship between the cost of the goods *first purchased* and *current revenues,* and it would be usual for these enterprises to cost their sales on the assumption that there is a first-in, first-out flow of costs; the costs of the items received last would be carried forward against future periods in the closing inventory.

In some instances sellers establish prices from time to time by applying predetermined mark-ups on the basis of moving average costs. In these cases periodic income might be measured most accurately by matching revenue with the average cost of the items on hand at the time of the sale; there is an assumption

of a moving average flow of costs.

The methods just described are well suited to meet the requirements of ***most*** business enterprises, and both have been generally accepted for a long period of time. I would guess that one of the main reasons these methods have been accepted without question for so long is because the flow of cost factors follows somewhat the same pattern as what might be assumed to be the flow of physical goods. If we accept the powerful evidence that cost factors are more important than physical identity it would seem that we arrived at the right answer while using the wrong reasoning.

The requirements usually associated with an assumption of a flow of cost factors on the last-in, first-out basis are—

1) Selling prices must be subject to change in relation to changes in replacement costs;
2) On the part of management there must be a covering of sales commitments with purchase commitments so as to avoid all market speculation;
3) The materials must be substantially homogeneous and interchangeable.

It has been argued that another condition should be that inventories should be relatively fixed in quantity, or should cover requirements of from three to six months, or that they should be large in relation to the turnover. Another condition frequently expressed is that the cost of raw materials should be large in relation to the total cost of the finished products. Personally, I do not regard these as essential conditions in recognizing a LIFO flow, but if any of these conditions exist in conjunction with the other three conditions, my opinion is that the LIFO method would be the only one which would result in a substantially accurate determination of income when prices are fluctuating. In other words it is a question of degree, and obviously the amount of the distortion of profits caused by using an incorrect method of inventory valuation will vary with the relative size of the inventory and the extent of the fluctuation in cost prices.

Illustration of LIFO

For purposes of illustration, let us assume that a company maintains a heavy inventory of raw materials; costs of production are relatively small and the total cost of the finished product is, to a large extent, composed of the cost of the raw material content. Sales prices are quickly influenced by changes in raw material costs, and in order to reduce the hazards of the business operation, the management follows a deliberate policy of not speculating in the commodity markets and covers sales commitments with purchase commitments. In these circumstances, it is clear that the raw material cost which should be absorbed against the revenue from each sale is the cost of the raw material that ***was purchased to cover that sale.*** In this instance there is a last-in, first-out flow of costs, and the opening inventory represents a cost which did not apply to the concurrent revenues of the period, and therefore is a cost which should be carried forward in the closing inventory. It does not matter that materials in the opening inventory were used physically to fill the orders during the period.

There are not a great many industries where these conditions are encountered; the last-in, first-out flow is usually found in such industries as the tanning of leather; the manufacture of petroleum products and steel; smelting, refining and manufacture of non-ferrous metals; and some textile operations. In these industries, the LIFO method is usually suited only to the major item or items of raw materials, and not to the countless ancillary items of inventory.

To illustrate as simply as possible the

effect of not adopting the LIFO method where it is appropriate, consider the following example. At the beginning of year one, a company has on hand 10 million lbs. of copper at a unit price of 10c per lb. — $1 million. During year one it purchases an additional 10 million lbs. of copper at a price of 30c per lb., and the copper content of goods sold during the year is 10 million lbs.; selling prices throughout the year are established so as to yield a normal rate of profit based on 30c copper. Using the LIFO method, cost of the copper content of the goods sold would be $3 million (the cost relative to the copper purchased) and the closing inventory would be valued at $1 million (the carry-forward of the cost of the opening inventory); the profit would represent a normal yield after the proper matching of costs and revenues and would be in keeping with the target established by the company. Using the FIFO method the cost of the copper content of the goods sold would be $1 *million* and the closing inventory would be valued at $3 *million* — (just the reverse of the LIFO calculation). However, the profit for the period would be $2 million in excess of the amount calculated by the LIFO method. Let us assume that in years 2, 3, 4 and 5 the cost of copper remains at 30c and the quantity of copper purchased equals the copper content of goods sold. Identical operating results would be calculated using the FIFO and LIFO methods. However, what goes up must come down, and history has shown that sooner or later, over the entire business cycle, prices always return to their original levels. In the sixth year the company purchases 10 million lbs. of copper at a price of 10c per lb. The copper content of goods sold is also 10 million lbs. and selling prices throughout the year are based on 10c copper. Using the LIFO method, cost of the copper content of the goods sold would be $1 million (again the cost relating to the copper purchased), and the closing inventory would be valued at $1 million (this value remained the same continuously from year one forward). As in all years, the profit would represent a normal yield and would be in keeping with the target established by the company. Using the FIFO method, however, the cost of the copper content of goods sold would be *$3 million* — $2 million more than the LIFO calculation. Because selling prices were based on 10c copper, whereas 30c copper would be costed under the FIFO method, the statement of profit and loss computed on the FIFO basis would probably show a large loss which would not be explained by any decrease in the volume of operations. To summarize: in year one, when prices were rising, profits calculated under the FIFO method would be $2 million in excess of the LIFO calculation; in years 2 to 5 there is no difference in the profit calculations; and in year 6 profits calculated under the FIFO method would be $2 million less than the LIFO calculation.

Effect on Profits

As a general rule, *on a rising price market,* the FIFO profit calculation will always be *greater* than the LIFO calculation; and on a *falling* price market the FIFO profit calculation will always be *lower.* As mentioned earlier, these differences are caused by relating *earliest* costs against current revenues, whereas the *level* of the current revenues is established in relation to *latest* costs. Phrased another way, at the end of year one in the example mentioned, the *same quantity* of the *same goods* was valued at $2 million *more* than the opening inventory, thereby adding $2 million to profits even though this profit had not been realized by sale. In year 6 the entry was reversed by deducting $2 million from profits. Because a *rising* price market is usually found during the "boom" period of the business cycle, and a *fall-*

ing price market is associated with the following "bust", the effect of not adopting the LIFO method where it is appropriate is to accentuate or exaggerate the swings in the cycle.

I will not dwell on the effects of exaggerated peaks and valleys in the business cycle, as the evils are well known. I will say, however, that they adversely affect the condition of the stock market, lead management to making unsound decisions, particularly with respect to expansion and financing, upset the judgment and opinions of our economists and bankers, and eventually aid in the general downfall of industry.

When the Wartime Prices and Trade Board first relaxed and later decontrolled the fixed price ceilings in Canada at the conclusion of the war, there were some startling increases in the price of many raw materials where for a number of years before there had been price stability. This created a situation where many industries, who had for some time recognized a last-in, first-out flow of costs but who had done nothing about it, were forced to adopt the LIFO method if their calculations of profits were to bear any relation to what was actually happening. Although many corporations had been using the LIFO method for years, the differences in profit computations were relatively insignificant, and it was not until the post-war violent price rise that the matter became one of great urgency. At that time many of us were preoccupied with other matters and had not given any recent thought to the LIFO method of inventory valuation and, as a consequence, its introduction at that time was looked upon with suspicion, and there was a certain amount of public discussion.

Frequent mention has been made of conditions in the United States and pronouncements of the American Institute of Accountants quoted. This is because that body has been very active in issuing accounting postulates for the information and guidance of its members. I understand that LIFO has not been a controversial subject in the United States since before the war and was introduced in corporate accounting at least as early as 1906. Subject to certain conditions, the LIFO method is accepted by the taxing authorities in the United States and the United Kingdom, and I believe that the leading accountants in Britain and Canada hold views similar to those of the American Institute of Accountants with, possibly, a small minority group dissenting.

Acceptance of LIFO in Canada

I first encountered the practice of the LIFO method in Canada in 1937, and it is my recollection that even at that time it was the method employed by a number of companies. There are now many more companies in Canada using LIFO and, as far as I can learn, no independent accountants have qualified their reports to shareholders to indicate that LIFO in these instances is not a generally accepted accounting principle. The Royal Commission on Prices, which rendered its report earlier this year, accepted LIFO as a proper method for computing income but it recommended that where the method was employed, "the present day value of the inventories should be indicated". I would assume that the Commission would like the balance sheet to show current value in some memo or note form.

The Dominion Taxation Division accepted a basis that came very close to the LIFO theory in connection with the wartime excess profits tax, except that the result was achieved through the establishment of an inventory reserve. It is also accepting a LIFO application somewhat in its regulations dealing with farmers and their basic herds. However,

I would not list the Taxation Division as being among the strongest advocates of LIFO.

The Opposition

So far, I have presented the arguments which have led to the general acceptance of LIFO, and now I will state the main arguments advanced by the dissenters.

In the first group I place those who contend that the use of LIFO, in effect, creates a reserve which reduces an inventory value below its current worth. Accountants, generally, think of a reserve in connection with inventories as being associated with something which can be controlled by the whims or desires of management, and as a consequence, public accountants, at least, have frowned upon inventory reserves, particularly insofar as they are provided out of current earnings. However, as I have tried to explain, the LIFO method, where used in appropriate instances, results in a scientific matching of costs and revenues and there is no opportunity for management to indulge in any manipulation. We may consider as being within this group, also, those who believe that the balance sheet, or the "What we have" statement, is more important than the profit and loss statement, and who therefore hold a strong opinion that the valuation of an inventory to be shown in the balance sheet should bear a direct relationship to current value. There may be some sympathy for this group, in that, for balance sheet purposes, it is of *more* than passing interest to know the current value of the inventory. However, rather than reject the LIFO method merely because it does not automatically disclose this information, I prefer to accept the recommendation made by the Royal Commission on Prices, and disclose current value by means of a note on the balance sheet, where this value is significantly different from that recorded in the accounts.

The remaining group of dissenters may be described as those who insist upon what they term "realities", and for whom realities consist only of material objects. I believe that this group is quite sincere in its supposition that the theory of costs and the flow of cost factors exists only in the minds of artful accountants, whereas it is *goods* in an inventory and the *physical identity* of these goods that is material. As representative of this group's view I quote from an address given by Mr. Charles Gavsie, a high official of the Income Tax Division, at the convention of the Dominion Association of Chartered Accountants held last September. Mr. Gavsie, a lawyer, stated in discussing methods of inventory valuation under the new Income Tax Act,

> Fundamentally, the taxing authorities are concerned with the ascertainment, in the greatest possible degree of accuracy, of the profits from a business in the particular taxation year under assessment and, naturally, look with disfavour upon any valuation of inventories which has the result of producing a figure of profit or loss more artificial than real. In valuing inventories, no difficulty will arise where the cost of the *actual articles on hand* at the close of the year is known. . . . The difficulty arises where the *facts* cannot be proven and assumptions are made. The so-called basic stock, average cost, LIFO and FIFO methods of inventory valuations are not, in fact, methods of valuation at all, but are rules of presumption as to the *identity* of the *inventory* to be valued. The new *Income Tax Act* does not lay down any rules for the identification of the inventory on hand at the end of the taxation year, and the acceptance or rejection by the taxation authorities of one or other of the presumptive rules of identification of inventories, where these cannot be accurately identified, remains a matter for determination, in the light of the facts of each particular case. In the past, the tax authorities have looked unfavourably in varying degrees upon such rules of presuming identity of inventory as basic stock,

LIFO and average cost. The fundamental reason for disfavour of these presumptions may be attributed to the fact that the taxing authorities considered that the basis of these rules is the very antithesis of sound business procedure, inasmuch as most things deteriorate through age and, consequently, every business is desirous of moving its old stock first . . . . The test [of an inventory value] must continue to be "in the absence of positive identification of inventory on hand, which rule of presumption is most likely to present the result most closely akin to reality?"[1]

Conclusion

In conclusion, I summarize the reasoning which makes LIFO one of the accepted methods of inventory valuation within the general term "cost". The main purpose to be served by the preparation and issue of periodic financial statements is to measure income or profits for the period as accurately as possible. Income cannot be measured accurately or scientifically by relating the cost of what can be identified physically as having been sold with the revenue from the sale. It can be measured accurately only by a matching of absorbed costs with concurrent revenues, and since each sale cannot be costed on an individual basis, there must be an assumption as to the flow of costs. In some instances this flow will be found, on investigation, to be on a last-in, first-out basis.

[1]*The Canadian Chartered Accountant*, October 1949, p. 164

Self-addressed Envelopes

MR. A. G. McBAIN, C.A., writing in *The Accountants' Magazine* (The Journal of the Chartered Accountants of Scotland) on a manual for the use of amanuenses (this long word is used on purpose!) in chartered accountants' offices concludes with the following rule designed to disinflate many of us,—

In sending out a stamped envelope addressed to oneself, the prefix "Mr" should be used instead of the suffix "Esq." A friend has interestingly written me about "Esq." as follows:—

> "The common use of 'Esq.' is something the pundits of the Lyon Office or Heralds College probably deprecate; they would doubtless define the categories of the population entitled exclusively to receive it, but all this may best be regarded as 'vieu jeu', 'played out', or completely out of date."

Cost Accounting

By Harry E. Clayton, C.A., R.I.A.

A discussion of the various elements involved in cost accounting

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THE purposes of cost accounting are as follows:

(1) To facilitate the preparation of financial results without the necessity of physical stocktaking. Consequently, the financial results should be obtained more expeditiously and at less cost. The latter factor, in my opinion, is not in all cases fully explored. I think many firms pay much too much for their cost accounting results.

(2) To allow industry to determine equitable and just prices for their various lines of merchandise and facilitate the determination of tendering figures to be submitted in connection with new types of contracts, etc.

(3) To allow for comparison of planned costs with actual costs, thereby acting as a check, when properly used by management, upon efficiency of the various departments of the organization.

(4) To facilitate an estimate of what costs would be under changed conditions, i.e. extra capacity, increase in idle capacity; or other peculiar changed circumstances such as the recent devaluation of the pound sterling.

What Is Costing?

What is costing? From a practical approach, I consider that costing is that science which develops *unit* costs as compared with bulk costs. A great deal of present accounting literature seems to presuppose that more detailed inventory records are required in costing than under a system in which cost accounting is not a factor. I do not agree. It is my contention that the cost records should be utilized to a great degree in place of, rather than in addition to, perpetual inventory records. As a matter of fact, the largest motor car manufacturer in Canada has no perpetual inventory records as such. Their bill of material, in conjunction with their purchasing and production records, act as and in lieu of actual perpetual inventory records. This is discussed more fully below in dealing with material costs.

Direct Labour

At this point, consider the question of direct labour. Direct labour is the labour incurred directly in the fabrication or manufacture of the article being produced. In our business — that is, clothing primarily on a made-to-measure basis, it is handled as follows. Approximately 90% of the direct labour costs in the clothing industry are incurred on a piecework basis. Consequently, the problem

of costing is simple. The direct labour, when incurred, is charged to a direct labour account and then relieved on the following basis: a labour specification sheet is developed for each type of garment manufactured, the operations being listed on the left-hand side of the sheet, and the piece-work rates inserted on the right-hand side. The non-piece-work operations are then priced on a unit basis on the basis of a time study developed by the factory department in conjunction with their past experience. In this way the total unit labour cost of each type of garment in each particular range is secured.

At the end of the month the shipping and sales records, which are in effect the same thing, are tabulated and the number of garments shipped in each particular range obtained. These are then multiplied by the aforementioned unit cost figures for such particular range. The resultant answer is used to relieve the direct labour in process account and to charge the cost of sales for the period. Based upon data secured from the factory and our own particular knowledge of the circumstances, an inventory figure is developed for the month-end and the difference between the debit and the credit sides of the direct labour in process account becomes the shop profit and loss for the month, and represents (presupposing a month-end inventory is correct) the variance between the actual cost of the non-piece-work operations incurred in the finished production and the basis in which it has been relieved from the labour in process account. This variance is, in our case, transferred to a shop profit and loss account in the factory overhead section of the accounts, so that our production department may be constantly aware of the variance between the cost of the non-piece-work operations, as submitted by them, and the actual cost thereof. A detailed analysis is prepared of this shop profit and loss figure, showing the variances by shops so that the factory department may take any steps necessary in order to rectify shop losses.

But why not relieve the labour process account and charge the finished goods account for the labour utilized in the finished garments, and then in turn relieve it and charge cost of sales as shipments are made? Theoretically, this is the sound practice, as it allows one to segregate the various elements of inventory into their various degrees of realizability. This, however, is primarily a theoretical argument and its practical application does not in most cases justify the work and cost involved in developing it. If this type of information is required at any particular time, it can readily be obtained with a little research and if it is of prime importance, in all likelihood it will be backed up by a physical stocktaking. Why, therefore, develop extra data which requires extra time and extra cost if it is not going to be utilized to the fullest? As a matter of fact, the largest motor car company in Canada merely dumps all of its direct vehicle labour into a labour in process account and lets it remain there until the finished car is shipped from the building. In other words, let us not burden ourselves down with extra cost work unless the effort justifies the expenditure. In the early depression years of the 1930's, Mr. Henry Ford personally requested the dismissal of his entire cost accounting division because he felt the cost did not justify the result. However, he ultimately gave way and reinstated a large proportion of it.

Another View

Before leaving the question of direct labour, a view may usefully be taken of the procedure in use by another large manufacturing company which fabricates a product requiring many hundreds of

parts, in the determination of their labour costs. It illustrates a rather ingenious method of arriving at reasonable costs with a minimum expenditure of time, effort and money to obtain the required result. The costing of all this detail, at first glance, seems tremendous. This particular company secures from its payroll department the labour incurred for the period, both direct and indirect, on such parts, and the amount of indirect labour included in the figure. The accounting department accordingly charges the indirect labour to a factory overhead account and the balance to direct parts labour in process account.

So far the mechanics are easy. The difficult part is on what basis to relieve the labour in process account for the completed units. The costing department secures from the engineering department a voluminous listing of all the parts going into the fabrication of the finished product. On the right-hand side of these sheets the engineering department inserts opposite each part its estimate of the standard hours or proportion of a standard hour of labour required to fabricate each particular part. This standard hour summary is, of course, duly certified by the engineering department. In addition, the costing department secures from the factory production department the actual production for the month, part by part. This, of course, includes the inventory on hand which is converted into terms of finished parts by the use of the equivalent performance method of inventory valuation.

Having obtained all of this required information, the costing department takes the engineering department's standard hours for each particular part and multiplies it by the actual production for the period as submitted by the production department. The extended standard hours are then totalled giving the resultant total standard hours utilized for the period in

After serving articles of apprenticeship with the Toronto firm of Gunn, Roberts & Co., Mr. Harry E. Clayton, C.A., R.I.A. was admitted to the Ontario Institute in 1942. Subsequently he served in the Treasury Cost Accounting Division of the Dominion Government in Ottawa. Upon his return to Toronto he joined Tip Top Tailors Limited as comptroller, and now also holds the position of secretary of that Company. Mr. Clayton is a degree member of the Society of Industrial and Cost Accountants of Ontario.

the production of the parts for the said period. This total standard hours is then divided into the total direct labour incurred for the same period. The result represents the actual rate of pay per standard hour for the period, which is then multiplied by the number of units produced of each particular part to arrive at the dollar value to be utilized in the relief of the direct parts labour in process account for the period.

Admittedly some degree of error sometimes results from the fact that the engineering department may overstate the standard hours required, for one part, and understate it for another part. However, by and large, the result appears to be a fairly equitable cost and the saving in time and man hours required to obtain the result, in my opinion, more than justifies the formula used. Incidentally, the standards set are constantly revised by the engineering department as circumstances and conditions alter, and as a further check the cost accounting division periodically checks the total standard hours utilized for the period under review with the actual hours worked as per payroll computations. Consequently, if any large variances occur between actual

and standard hours, the costing department is able to act as "watch dog" and point this out to the engineering department which then closely analyses the matter in order to rectify any error.

Direct Material Costs

In the clothing industry development of direct material costs is a relatively simple matter. Specifications of the yardage and trimmings required are obtained by the costing department from the designing and production departments which obtain such information by making lays of the average size for each particular type of garment to be manufactured. The costing department then secures from the woollens or purchasing department details of all the cloths to be utilized in each specific range for the coming season. These details, of course, include the cloth number, the actual yardage on hand and on order and the related laid-down cost. The costing department then extends these figures for the purpose of arriving at the actual laid-down cost of yardage in each particular range. They then add a safety factor to take care of the possibility of the public purchasing more of the higher-priced cloths in the range than the lower-priced cloths and utilize the resultant figures for the purpose of pricing the material specifications or bills of material obtained from the designing and production departments. Materials are charged as purchased to a material inventory account and upon the basis of the material unit costs arrived at as aforesaid. The material inventory account is relieved for shipments and charged to cost of sales by multiplying the unit material cost by the number of garments shipped in each specific range.

As a check upon the accuracy of the aforementioned, the costing department proceeds as follows: all made-to-measure orders are cut individually and the ends-cutter, when cutting off the cloth, inserts on the order the actual yardage used. These orders are then funnelled back to the costing department and cards punched for the actual yardage used, the cloth number used and the laid-down cost. These are then tabulated in order to check upon the accuracy of the figures arrived at as aforementioned for costing purposes. Actually, the latter records do not form part of the company's books of account, but merely act as a verification of their accuracy. If any large discrepancy occurs, which may happen because of changes in the type of garments being worn during the season, and so on, a journal entry is made correcting the cost in light of the tabulated run. At the same time the bill of material utilized for costing purposes is revised accordingly.

One of the large motor car manufacturers, like many others, also uses a bill of material or material specifications for the purpose of costing. The material costing under any other basis would seem to be, to say the least, quite a headache, because of the many hundreds of parts required in the manufacture of one vehicle. The motor car costing department obtains from the engineering department detailed lists of all the parts required in the manufacture of the car and it then secures from the purchasing department the laid-down cost of these items and extends it for the purpose of arriving at the unit direct material cost of each type of vehicle. These unit material costs are then multiplied by the actual shipments of each particular type of car for the month and the resultant figures are then relieved from the material in process account and charged to cost of sales.

Incidentally, the bills of material or material specifications are utilized by the motor car manufacturers the same as the clothing manufacturers for the

purpose of making purchases; that is, the planning department supplies the purchasing department with a schedule of anticipated production by vehicle types for the period and the said purchasing department, utilizing the bills of material, schedule their purchases accordingly. In the ordinary sense of the word, no perpetual inventory records are kept, but for purposes of constantly checking the inventory, the cost accounting department spot-checks parts by taking their opening inventory and then adding thereto the purchases for the particular part as supplied by the purchasing department and deducting therefrom the part usage in accordance with the production reports. The resultant figures, naturally representing the inventories on hand, are then physically checked.

Factory Overhead

There are many types of overhead, such as factory, selling and general administrative, shipping, etc. Let us for the moment concentrate on factory overhead. There are many bases of allocating factory overhead to a product. It may be direct labour, but many other methods can of course be utilized. The basis used is not important so long as the base factor utilized results in an equitable distribution of the factory overhead to the products involved.

In arriving at the rate to be used in our own costs, we review the relationship of the percentage of direct labour for several previous years to the overhead expenses for the same periods. In addition, we consider what our anticipated production will be for the coming year and any unusual circumstance which might tend to substantially alter the rate in relation to prior years. For example, if the union is securing an additional cost of living bonus, which we charge to factory overhead, it will affect the rate that should be utilized in the coming year. After a great deal of analysis, we then attempt to set the rate. The mechanics are simple, but the determination of the rate is very important. If we try to be conservative and overstate the expected rate, we understate the profit to the directors during the first part of the year. In addition, we are faced with embarrassing questions as to why we overstated the rate. We may be told that because we overstated the rate, our prices were too high and we consequently lost business. On the other hand, if for one reason or another, we understate the rate, we overstate our monthly profits to the directors and are faced with the problem of the unabsorbed burden.

The Unabsorbed Burden

What do we do with the unabsorbed burden? Do we increase our costs accordingly for the remainder of the year and show losses during the latter part of the year, or increase our selling prices and pass the burden on to our customers of the latter part of the year? The problem is a complex one and requires a great deal of study. It can and must be decided by determining the approximate proper rate in the first instance.

During the early war years when I was with the Treasury Department in Ottawa, Mr. Ralston, then Minister of National Defence, asked for a special investigation of the boxing or crating costs of two large manufacturers in the same industry, as he could not understand why there should be such a large discrepancy in the prices submitted by them. The answer turned out to be very simple. Company "A", in determining their boxing costs, took their labour and material and added factory overhead as a percentage to the direct labour incurred. Company "B", on the other hand, determined their price strictly on the basis of labour and material. No overhead was charged for boxing whatsoever. They did, how-

ever, absorb their overhead, which is quite natural. This was absorbed on a labour basis on the finished cost of their prime products. Which one would you consider correct? Personally, I believe that they both achieved a satisfactory result, even though their answers were substantially different.

Other Overheads

Turning now to the other overheads, such as general administrative, selling and shipping, and the like, the basis of allocation to the various products manufactured is inconsequential so long as the bases used result in an equitable distribution of the said costs over the products produced. The bases may be a percentage of direct labour in the cost of sales, or of prime material and prime labour in the cost of sales, or of the prime labour, material, and factory overhead in the cost of sales, or some other equitable basis. I am sometimes astonished by the number of organizations which meticulously determine their direct labour, direct material, and factory overhead costs when setting selling prices, and then add a rough percentage figure to cover their other overhead expenses and profit. In many medium-sized businesses they do not fully appreciate the mechanics involved in arriving at an equitable percentage figure to be applied to cover these types of expenses. As accountants, we have a great deal of educating to do in this respect.

The allocation of overhead to subsidiary products being manufactured deserves consideration. There seems to be a great tendency in industry generally to minimize the fact that an equitable overhead rate should be applied to their subsidiary products. Some such attitude as the following is common — "We will take this item as a fill-in just to cover our labour and material and a small portion of our overhead cost." To a degree this procedure may be sound, but it is the duty of accountants to review the facts fully in order to determine that the overhead being applied to the subsidiary products at least takes care of the *actual operating overhead expenses incurred in connection therewith.* Many businesses make tremendous sales and yet show little or no profit. The answer lies in large part in (1) not estimating the proper percentage that should be applied for their selling and administrative, general and shipping expenses, and (2) their inclination to sell subsidiary products without covering sufficient factory overhead in addition to the other types of overhead.

Need for Adequate Costing Procedures

A few industrialists, and even some professional accountants, do not consider it essential to have adequate costing procedures, providing a stock-taking is carried out at least once a year. When a concern fabricates more than one article, such an argument is unsound. Granted, even with proper costing procedures, physical inventories are necessary, but without adequate costing data, what good is a physical stock-taking? How can a manufacturer allocate his costs between (1) the various products produced and (2) the finished goods and work in process of each type of article manufactured, if he has no semblance of a cost accounting system? He cannot adequately value his year-end inventory on the basis of cost or market, which must present a dilemma to the public accountant certifying such a manufacturer's balance sheet.

Auditors should make a much more thorough test of costs than they have done heretofore. Because of the magnitude of the operation, and the peculiar problems involved in each particular business, auditors are generally not able

to check fully the year-end inventories, and rely in consequence to a large degree upon certificates from management officials. We can do ourselves and our clients a great service by making a more detailed check of the costing procedures utilized by the company, because in the final analysis if they and the internal check are sound, the year-end inventory can to a great degree be verified without physically checking it. In addition, a great many companies, both large and small, use cumbersome, detailed, slow, and expensive methods of costing. We should not readily accept costing procedures because they are orthodox, but should seek to develop more ingenious methods, even though they may seem unorthodox.

A Letter from a Reader

IN THE hope of starting a controversy and also because we think P. G. Wilmut, the secretary-treasurer of a well-known contracting firm, has raised an interesting point, we publish a letter received recently. For obvious reasons we have tried to substitute in the specimens given by him fictitious names and addresses.

Montreal, Feb. 24, 1950

Sir: I was interested and amused by the item on page 68 of the February issue entitled "Silence is Golden".

My firm has for many years been receiving statements bearing the rubber stamp as in this specimen:

> If this statement is incorrect, please communicate at once with our auditor
>
> S. A. Greenpencil
> Chartered Accountant
> Room 400 5801 Yonge St.
> Montreal

Whenever the statement has not agreed with our books we have been very glad to advise the auditor concerned of that fact.

Lately we are receiving statements bearing a rubber stamp as in this second specimen.

> PLEASE EXAMINE this statement carefully. If it does not agree with your records at the date indicated, please report differences DIRECTLY to our auditors —
>
> Debit, Credit & Co.
> 980 West Hastings St.,
> Toronto, Ontario
>
> If no differences are reported to our auditors, this statement will be considered correct.

We very much resent the closing sentence: "If no differences are reported to our auditors, this statement will be considered correct." This would seem to be an attempt to make us believe that we are under an obligation to notify auditors of discrepancies in statements. One naturally wonders what the penalty is if one does not do so.

We have always felt that any attention we paid to statements bearing auditors' stamps was a courtesy on our part and not an obligation, and as far as we are concerned we shall refuse to comment on any statements bearing the rubber stamp containing the wording quoted herein.

P. G. Wilmut

Confirmation of Accounts Receivable And Observation of Physical Stocktaking

A summary of a panel discussion at the 47th annual meeting of the D.A.C.A., September 14, 1949

THE CHAIRMAN, Mr. J. R. M. Wilson, announced that the discussion would be on the subject "Should confirmation of accounts receivable and the observation of physical stocktaking be considered part of normal auditing procedure?" He explained that the Accounting and Auditing Research Committee of The Dominion Association of Chartered Accountants had for some time been giving careful consideration to the possibility of issuing one or more bulletins on auditing subjects and that they had come to realize that if such bulletins were to deal with auditing procedures, it would not be possible to avoid consideration of accounts receivable and inventories — the advisability of confirmation of the former by direct communication with the debtors and verification of the latter by attendance at physical stocktaking. Discussion had revealed a wide diversity of opinion, and the committee had been unable to decide what was the generally accepted practice of the auditing profession in Canada. The committee was hopeful of receiving some enlightenment on this subject as a result of the forthcoming discussion.

Topic Considered in 1939

Mr. Wilson pointed out that the subject was not new to the Dominion Association. The report of the Special Committee on Auditing Procedure of the American Institute of Accountants, issued in May 1939, which required as normal procedure the confirmation of accounts receivable and attendance at physical stocktaking, had been published in *The Canadian Chartered Accountant* during 1939 and considered by the then Committee on Accounting Research. That committee reported at the annual meeting of the Association in 1940 that, in view of the war and the serious staff problems in the offices of most of the members of the Association at that time, it would be untimely to extend the amount of work which had customarily been undertaken under existing arrangements with clients. Moreover, the members of the committee reported that they were not satisfied of the practicability of laying down a rule on the making of physical tests of quantities. Under these circumstances it was suggested that consideration of the extension of auditing procedures in Canada under these two heads should be deferred until after the war. The war being over, the committee felt that further consideration should now be given to the question.

Members of the Panel

The chairman of the discussion panel

was Mr. K. LeM. Carter, a partner in the firm of McDonald, Currie & Co. in Toronto, a past president of the Ontario Institute and a member of the Accounting and Auditing Research Committee of the Dominion Association. The other members of the panel were:

Mr. J. Valiquette, a partner in the firm of Anderson & Valiquette of Montreal and a vice-president of the Quebec Institute;

Mr. W. J. Ayers, a partner in the firm of Sime, Ayers & Co. of Toronto;

Mr. J. G. Brown, resident partner in Kitchener, Ontario of the firm of Thorne, Mulholland, Howson & McPherson, former alderman and mayor of that city and at present a member of the Legislative Assembly of the Province of Ontario;

Mr. J. R. Church, a partner in Price, Waterhouse & Co. in Vancouver, immediate past president of the B.C. Institute and member of the Executive Committee of the Dominion Association;

Mr. Carman G. Blough, for the past four years Director of Research of the American Institute of Accountants. Mr. Blough has had many other important posts in the accounting profession in the United States, having been the first chief accountant of the Securities and Exchange Commission, a partner in the firm of Arthur Anderson & Co. and during the war Director of the Procurement Policy Division of the War Production Board of the United States.

Procedures in the United States

Mr. Carter first called on Mr. Blough to tell something of the considerations which led up to the adoption of the 1939 bulletin by the American Institute and what the results of its adoption had been.

Mr. Blough said that the bulletin entitled "Extensions of Auditing Procedure" was the first bulletin put out by the American Institute Committee on Auditing Procedure. The American Institute has two committees, one for auditing procedures and one for accounting principles, and these two committees have put out a total of over fifty bulletins. Only two of these bulletins have been approved by the general membership of the Institute; these two both deal with the subject under discussion and are the only two that have been laid down as rules. These requirements (that the auditor if he is to issue an unqualified report must communicate directly with debtors and attend at the taking of physical inventories or make physical tests of the inventory quantities in order to satisfy himself that the quantities are correctly stated) are referred to as "extensions of auditing procedure" from the name of the bulletin dealing with them. It is specified by the American Institute that in the absence of these two procedures the auditor must not issue an unqualified report unless their application is unreasonable or impractical and that even though alternative procedures have enabled him to satisfy himself and to issue an unqualified report he must still refer to the omission of the required procedures.

Mr. Blough then explained that these "extensions of auditing procedure" were laid down largely as a result of the McKesson and Robbins case. The investigation into this fraud carried out by the Securities and Exchange Commission early in 1939 revealed that the physical inspection of inventories would have disclosed the fraud. All the experts testifying at this hearing indicated that although they believed in confirmation of accounts receivable and in the physical examination of inventories they did not insist on the application of these procedures as a general rule. As a result of the agitation which followed the disclosure of the variations in practice of public

accountants in respect of these procedures the accounting profession came to believe that some sort of a formal statement was necessary in order to obtain a little more uniformity in future. It was also felt that a statement of this kind would help to clarify the position of the profession in the mind of the public.

The special committee appointed to study this question reported a month after the completion of the hearings with a recommended statement on extensions of auditing procedure. After a thorough discussion at the annual meeting of the Institute the statement, slightly amended, was issued in 1939.

The original bulletin stated that the auditor who omitted the prescribed procedures because they were not practical or reasonable under the circumstances, but who was able to satisfy himself by alternative methods, need not include any explanation of his omission and the reasons therefor in his report. In 1942 an amendment to the original bulletin was issued and adopted by the membership requiring disclosure of failure to carry out these audit procedures in all cases, regardless of whether they were practical and reasonable and even though the independent accountant may have satisfied himself by other means.

Current Practice in the United States

After describing the present requirements regarding "extensions of audit procedure", Mr. Blough then proceeded to show the effect of these requirements on the practice of members of the Institute. He told how much difficulty and confusion had resulted from the lack of common understanding of what an audit is, since a surprisingly large portion of the practice of many of the smaller members of the American Institute consisted not in preparing audit reports but in rendering accounting services. Mr. Blough stated that about a year and a half ago a proposal was made to amend still further the requirements for extended audit procedures whereby an accountant preparing statements on which he was unable to express an opinion should clearly state that he could not express an opinion and give his reasons for his inability to do so. This proposal had stirred up a great deal of discussion and the indications are that probably over half of the accounting engagements in the United States do not involve either confirmation of receivables or physical testing of inventories although in the cases where this is not done no opinion or a qualified opinion is given.

Mr. Blough gave the results of a recent survey which he had made among a number of practising American firms, which indicated that the bulletin was being observed but only among the large firms was it generally accepted practice to confirm receivables and to attend at stocktakings. Nevertheless, among the medium and small firms where it was not the usual practice to perform the extensions of auditing procedure unqualified opinions were not expressed unless the extended procedures were carried out.

Mr. Blough pointed out that in many cases reports were being issued without any opinion and many readers of these reports did not realize that they were not getting an unqualified audit report. Accordingly, further consideration has been given to the auditor's responsibilities when reports are issued without an opinion, and this matter has been the subject of a new bulletin by the Institute. It was found that where reports were qualified, they were qualified in one of two ways: either by noting the limitation of the examination in the scope paragraph or by noting an exception in the opinion paragraph.

I. CONFIRMATION OF ACCOUNTS RECEIVABLE

The chairman of the panel, Mr. Carter, then explained that the panel speakers would argue on the side which had been assigned to them and would not necessarily be expressing their own convictions. The discussion would first deal with confirmation of accounts receivable, Mr. Ayers speaking in favour and Mr. Valiquette opposed.

Mr. Ayers For

Mr. Ayers developed the idea that in the recent past there had been a change in the generally accepted idea of the auditor's function from that of a mere checker to a verifier and consultant and that there has been a tendency to reduce the time spent in long and laborious checking routines and to substitute emphasis on the careful presentation and interpretation of facts. The confirmation of accounts receivable was the easiest, fastest and most efficient way of verifying these assets and consequently was in accordance with the times. The confirmation of bank balances had been regarded as an essential for a good many years, and in a legal decision in 1904 it was stated that "it is the duty of the auditor to take proper steps to verify the existence of assets stated in the balance sheet", which shows that the confirmation and verification was accepted even at that early date. The present day auditor can, therefore, hardly satisfy himself without some form of confirmation of receivables. No auditor ever encountered a case of fraud in the normal course of his work except pilfering and petty cash shortages which could not have been detected or stopped if confirmations had been sent at an earlier date. Although the Latin derivation of the word auditor was "hearer", it had come to apply by 1879, the date of the English *Companies Act*, to a checker of items not necessarily included in the books and the idea of auditing as hearing or just checking had been by that time changed to the idea of verification. An auditor who does not confirm accounts receivable is therefore doing a job 50 or 100 years out of date. The course of history shows a steady development of auditing from routine checking to verification, and confirmation as a means of verification. This development is further borne out by experience in the United States and Canada where confirmation of receivables has been accepted for many years as a usual method of verifying this asset.

If confirmation were accepted as a principle, the only problem was one of application. Obviously 100% positive confirmation was impractical in most cases and it is probably the realization of this fact that has caused all the argument on the subject. Negative confirmation is no trouble at all and in most cases a high percentage sample could be obtained without very great difficulty. The chief difficulty is to decide how much of a sample can be considered to be sufficient and there is, unfortunately, no hard or fast rule that can be laid down to assist the auditor in deciding this.

In Mr. Ayers' opinion a qualification in the auditor's report was necessary if he wanted to confirm receivables and was prevented from doing so, but he did not believe that it was possible or desirable to lay down a rule to the effect that one must confirm or qualify. There are circumstances in which confirmation may not be necessary and in the final analysis it is the auditor's responsibility to decide what needs to be done since he is engaged to render an opinion, not tell what he has done. It was not desirable to reduce the auditor's responsibility to a matter of rules. Although confirmation of accounts receivable is the accepted procedure for verification of

these assets, its voluntary omission by the auditor for good and sufficient reason should not require a qualification in his report.

Mr. Valiquette Against

Mr. Valiquette speaking on the negative of this question listed his objections to the proposal that confirmation of accounts receivable should be considered a necessary part of normal auditing procedure under three headings — theoretical, practical and legal. He agreed that, theoretically, the confirmation of accounts was in many cases the best and sometimes the only suitable method of verification, but said that where there is an adequate system of internal check in force with a proper control on sales, cash and credit notes and where the auditor is able to satisfy himself of the existence of such a system and to subject the accounts to a comprehensive examination to determine their authenticity and liquidity, there is no need to confirm normal trade accounts.

From the practical point of view in order to convince management of its necessity the profession would have to prove that the procedure is in the interest not only of the profession but of the shareholders and proprietors and the public generally. To require that the auditor must qualify his report when he has not confirmed receivables would be futile. There are cases where a great many of the accounts have been paid by the time the confirmations are sent so that some debtors and even the client may be indisposed by the request to confirm. In practice it frequently happens that all accounts are not confirmed so that a constant follow-up is required during the whole of the audit while the same problem of valuations and investigation remains to be done in any case. In addition, if confirmation of accounts receivable were made a normally accepted procedure, it might cause undue hardship to the sole practitioner and to the medium and small-sized firms whose organization would not be able to handle such a volume of work at peak periods. Furthermore, confirmation is not an infallible means of detecting errors and frauds.

From the legal point of view it may be stated that there is no statutory requirement regarding the audit of a sole proprietorship or partnership, while in the case of a company the audit has to conform to the statutory provisions of the relative Act. The book *Accountants and the Law of Negligence,* by Summerfield and Reynolds, contains certain comments on outstanding debts, to the effect that no general rule can be laid down defining the duties of auditors in all circumstances and cases. It is necessary to determine by whom he was appointed, the circumstances of his appointment and the matters with which he was required to deal since, where negligence is alleged, it is essential to consider the circumstances in which the auditor is alleged to have been negligent, for his duty may well vary according to the particular circumstances in which he was discharging his professional duties.

The chairman then asked Mr. Ayers to elaborate on his statement that although he felt that receivables should be confirmed he was not certain that in the absence of confirmation qualification should be required. Mr. Carter suggested that perhaps this was because in a statutory engagement the absence of a required procedure would necessarily be reported by the auditor in his statement that all the information and explanations required had been obtained. Mr. Carter asked what corresponding safeguard there was in the case of non-statutory audits. Mr. Ayers replied that he had been referring primarily to the audit of incorporated

companies but he felt that in any engagement the confirmation of receivables should be accepted practice and where the auditor felt it should be done, and it was not done, he should qualify his opinion.

II. ATTENDANCE AT PHYSICAL STOCKTAKING

Mr. Church then presented the case in favour of attendance at physical stocktaking. He prefaced his remarks by commenting on the fact reported by Mr. Blough that many auditors in the United States avoided the "confirm or qualify" requirement by not expressing any opinion. This could not be done in the case of statutory audits in Canada because an auditor was required to give an opinion and this different situation had to be kept in mind when considering the American experience with these extensions of auditing procedure. Mr. Church based his arguments on the same points as used by the American Institute in explaining the need for their first bulletin. The members of the Dominion Association held themselves out to the public as proficient in accounting practice and audit procedure. However, financial statements are not factual documents and in expressing an opinion on statements the auditor must use his judgment. There is also a grave question on the exercise of judgment in the application of technical skills.

It was generally agreed that the day is long past when we can confine our examination to the written record and the books of account; we are always careful to obtain independent confirmation of bank balances; many auditors require independent confirmation of receivables; it is generally accepted practice to examine securities or to require certificates from reputable custodians. Is it not a little ridiculous to stop our verification at that point and to accept what in many cases is the principal asset without any independent verification of its existence? The expression of an opinion on inventories necessarily involves consideration of the company's own procedures as to the methods of internal control of stocktaking and the auditor's examination could be made easier and faster if whatever verification procedures we adopted were supplemented by observing the physical stocktaking. Mr. Church then quoted the American Institute bulletin to indicate that the auditor was not accepting responsibility for physical quantities or condition since these things were beyond his normal professional competence. It must never be overlooked in discussions of the extension of auditing procedure to include observation of physical stocktaking that these additional procedures are still only part of the procedures to be adopted for the verification of inventories. The members of the Dominion Association were not by any means the only auditors in the country, and the insistence by the Association on the adoption of additional procedures as a matter of routine would greatly strengthen the prestige of the Association in comparison with non-members.

Mr. Brown Against

Mr. Brown stated what he considered to be the two basic assumptions on which this discussion should be based: first, if the proposed extension were adopted it must be part of regular audit procedure and not one indulged in on special circumstances only; secondly, that it will cover the whole inventory and not a part only. This assumption is at variance with the arguments advanced by those favouring the extension of audit procedures regarding inventories but since errors in inventories of a serious

nature will, in most cases, be wilful, they are more likely to be found in the portions not examined than in the portions examined and a complete test would therefore appear to be essential.

The whole idea of attendance at physical stocktaking is comparatively new as far as Canadian practice is concerned and as yet no one appears to have come forward to maintain that we should be responsible for inventory quantities as well as values. Nowhere in the various governing Acts will you find any suggestion that auditors are responsible as appraisers or valuers or experts in materials.

The principal objections to the extension of audit procedures to include observation of inventory taking could be stated under three headings: (1) resentment of the client, (2) impracticability and (3) incompetence. The problem of who is to absorb the extra cost and why we should stop at inventories and not continue to capital assets should also be considered.

On (1) Mr. Brown believed that most clients would object to any suggestion that the auditor should observe physical stocktaking as a reflection on the clients and their staffs. On (2) it was obviously going to be impractical for members of the Association to carry out this procedure as long as most clients continue to close their books at December 31. In most offices the staff was normally kept completely occupied with rush jobs for the first few days in January and there would simply not be any one available to do any additional work. On (3) there were very few auditors who ever had the opportunity or the desire to go beyond the factory door in order to acquaint themselves with the many ramifications of the manufacture of the company's products. Under these circumstances it would obviously be absurd for auditors to set their judgment of inventory quantities and conditions against that of those who were devoting the whole of their time to the study of these matters.

As to the objection that by failing to adopt this procedure we were certifying to a balance sheet a substantial part of which we had been unable to verify, this objection was serious but not unique as there are many other cases in which we accept equally important items on the certificate of management — for example, the actuary's certificate on insurance company reserves. In many cases, municipal audits, stock exchange audits, and many others, we use special form reports that indicate what we have done and not done and we should be able to deal with our failure to verify inventory quantities in the same way.

Mr. Blough In Rebuttal

Mr. Blough then spoke for a few minutes in rebuttal of Mr. Brown's arguments. Admitting the difficulties inherent in the extended inventory procedure, he felt that most of them were more apparent than real. As far as the client's objections were concerned, the position was simply that if a client wanted an unqualified expression of opinion he must be prepared to submit to whatever procedure the auditor considered necessary. The argument of impracticability was also serious but not insuperable. In the United States a similar situation exists but it has been overcome to a considerable extent. There are many tests that can be performed during the year; an auditor need not be present at the time of stocktaking to make some test counts; and in cases where the company maintains a running book inventory, tests can be made at any time during the year to assure the auditor that the inventories are in agreement with the records. As for the alleged incompetence of the auditor to perform this work, an auditor

who knows absolutely nothing about the company's product cannot under any circumstances express an opinion on the validity of his financial statements. Mr. Blough admitted that it was true that auditors are not appraisers but pointed out that they are not trying to pass as valuers of the inventory. There are cases where the auditor is helpless to determine what is being inventoried but, by helping to set up a properly controlled system of taking inventory and by discussing the procedures actually being carried out with the employees engaged in the stock taking, he can get a reasonably good idea of the nature and quantity of the stock unless there exists a conspiracy of improbable proportions. He remarked that although an unskilled auditor might not be able to tell exact quantities or grades he could certainly tell whether there was any inventory at all or not.

Should Procedures Be Laid Down?

The chairman then called on Mr. Clem L. King, the Association's research director, to speak on the question of whether the Research Committee should lay down any auditing procedures. Mr. King set out his arguments in favour of having auditing procedures laid down by the Association as follows:

He maintained that formal statements on auditing procedure would—

(1) Emphasize the changes that accrue over the years;

(2) Provide an accepted floor or minimum but would not set any ceiling;

(3) Provide a generally accepted definition of adequacy for use by the members in assessing the adequacy of their own procedures;

(4) Provide a guide as to when qualification was necessary;

(5) Help the users of financial statements to know what the auditor did to arrive at his opinion;

(6) Clarify the anomalous situation resulting from the absence of such standards in Canada. Procedures are followed by some offices with respect to statements which are to be filed with the SEC in the United States, yet the same procedures are not followed with respect to other companies. This situation may well lead to difficulties in the Courts at some time if it is ever asked why extended procedures are necessary with respect to United States companies but not to Canadian ones.

(7) The existence of such standards might forestall Government intervention such as now exists in the United States.

Mr. King's summary of the arguments against the issuing of required procedures was as follows:

(1) As a professional man it is the auditor's duty to act in accordance with his own thinking. He should not be limited to applying certain laid-down procedures to each type of engagement.

(2) Many people feel that if the Dominion Association were to lay down procedures it might be regarded as assuming some of the liability for determining what procedures are sufficient in specific instances as well as detracting from the professional position of the individual practitioner.

(3) It may be objected that laid-down minimum standards will come to be regarded as complete descriptions of necessary procedures.

General Discussion

The meeting was then thrown open for general discussion. A wide variety of opinions on all the points discussed by the panel members were expressed. There seemed to be a feeling among many of the members that it was objectionable to have laid-down standards and that the laying down of any standards, even minimum ones, tended to detract from the professional nature of the au-

ditor's work by making verification a routine performance of a standard programme and removing the scope for exercise of the auditor's discretion and judgment. This was held to be objectionable by several speakers who stated their belief that the auditor should base his certificate on his professional opinion backed by what in his judgment were the necessary procedures to enable him to express such an opinion and that no laid-down standards were required.

External v. Internal Evidence

There was also some discussion on the relative validity of internal and external evidence. It was held that the proposed extensions of auditing procedure indicated an increased tendency to rely on external evidence as opposed to internal. Several speakers pointed out that the superiority of external evidence over internal lay in the very fact that it was external and therefore more likely to be independent and reliable. It was pointed out that reliance on independent checking of all phases of a client's operations is generally accepted as desirable either in the form of "internal check" or by independent examination or confirmation by the auditor.

Meaning of Attendance at Stocktaking Misunderstood

There seemed to be a general lack of agreement as to what actually was involved in the physical attendance at stocktaking. Most of the opponents of any extension of this phase of generally accepted procedure objected to it on the grounds that auditors could not and should not set themselves up as experts in materials or in the proper determination of the quantities or conditions of goods. Mr. Blough, called upon again to clarify the position of the American Institute in this matter, advised that as far as he knew no accountant in the United States had ever been held responsible for the determination of inventory quantities. He pointed out that the purpose of requiring the extended procedure was to give the auditor a greater opportunity of satisfying himself that the management's *methods* of determining quantities were such that would reasonably lead to a proper determination. Despite this statement by Mr. Blough there were a number of other speakers who felt that the auditor's incompetence made attendance at physical stocktaking a useless procedure. However, one speaker pointed out that attendance at inventory taking was a valuable way for the auditor to become familiar with the client's business and thus to reduce his incompetence. One officer of a large corporation stated that he felt that the auditor's attendance at stocktaking was of considerable value to the corporation.

Time of Confirmation

There seemed to be less specific objections to the confirmation of receivables although several speakers were afraid that the proposed laid-down procedure would require this to be done at the balance sheet date and thus the element of surprise would be lost and the problem of peak-period work intensified. There was a good deal of discussion on this point but it seemed to be the general feeling that confirmation of accounts receivable could be done other than at the year-end without detracting from its usefulness. As in the case of inventories there seemed an unwillingness on the part of some speakers to accept the contention of the advocates of the extensions of procedure that the primary purpose of the extended procedure was to enable the auditor to evaluate the reliability of the client's *accounting system* rather than to verify the specific year-end assets but the majority of the speakers appeared to accept this position.

Desirability of Guidance by the Association

There was some further discussion on the primary question of whether procedures should be laid down at all, during which it was suggested that bulletins served a useful purpose in passing on knowledge and information to all members. It was also suggested that in view of the existence of such bulletins and requirements in the United States some statement by the Dominion Association was essential for the guidance of the members especially if the Dominion Association felt that the extensions were not necessary.

The general feeling of the members present appeared to be that the two questions, accounts receivable and inventories, should be dealt with separately since there was by no means as much agreement on the desirability of the latter as on the former.

Professional Notes

BRITISH COLUMBIA

Mr. Carson G. Manzer, B.Com., C.A. announces the opening of an office for the practice of his profession at Pacific Coast Fire Bldg., 325 Howe St., Vancouver, B.C.

NEW BRUNSWICK

Moncton Chartered Accountants Meet

An informal meeting of the chartered accountants of Moncton, N.B. and Amherst, N.S. was held on Friday, March 31 at the Moncton Curlers' Association. Following a dinner, proposals were advanced for the formation of a chartered accountants' club to embrace the members in the two associated cities. The club would hold regular dinner meetings at which time matters of interest to the profession would be disseminated by means of lectures and informal talks.

Members of the Moncton Students' Society were guests of the meeting. Mr. Charles W. Campbell, C.A. spoke on report writing and Mr. W. A. Morrell, F.C.A. passed along a few of his own experiences as an auditor in the Maritimes. It was planned to have another dinner meeting in the near future when the formation of the proposed club would be completed.

ONTARIO

Mr. Philip F. J. Kendall, C.A., announces the opening of an office for the practice of his profession in the Royal Bank Bldg., Stratford.

* * *

Ottawa Chartered Accountants Club

About 125 chartered accountants and students have been attending the monthly luncheons of the Ottawa chartered accountants club. Guest speakers have included Mr. George R. Heasman, director of the Trade Commissioner Service of the Dept. of Trade and Commerce, who spoke on "A Two Million Dollar Sales Force"; Mr. W. L. Taylor, assistant general manager of Imperial Oil Ltd., who talked on the future of western oil; Mr. S. M. Finlayson, general manager of the Canadian Marconi Co., who spoke on "Television".

* * *

Millar, Macdonald & Co., Chartered Accountants, Winnipeg and Toronto, and Mr. A. Douglas Downie, C.A., Toronto, announce that their Toronto practices are now being conducted under the firm name of Millar, Macdonald & Downie, Chartered Accountants, with offices at 350 Bay St., Toronto.

SASKATCHEWAN

Mr. W. T. Scott, C.A., resident partner in Ronald, Griggs & Co., Chartered Accountants, Saskatoon, announces that he has acquired the practice of Mr. W. S. Ronald, C.A. Hereafter the practice will be carried on under the firm name of W. T. Scott & Co., Chartered Accountants, with offices at 104 Grain Bldg., Saskatoon. Mr. V. D. Hamilton, C.A. will be associated with Mr. Scott.

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Saskatchewan Institute's Annual Meeting

The Saskatchewan Institute's annual meeting for 1950 will be held on June 23 and 24 in Waskesiu, the heart of Prince Albert National Park. The slogan of this meeting is to be "A little work and a lot of fun"!

* * *

Regina Chartered Accountants Club

At the April luncheon meeting of the Regina chartered accountants club Mr. Lloyd C. Slater, C.A. spoke on "Some Aspects of Oil Accounting". Mr. H. A. Hunt, C.A. presided.

QUEBEC

Quebec Students' Society

The February dinner meeting of the Quebec Students' Society was held on February 23, at the Queen's Hotel, Montreal. The guest speaker, the Hon. D. C. Abbott, K.C., Minister of Finance, gave an address entitled "Preparing the Budget". He was introduced by Mr. J. A. de Lalanne, C.A., and thanked by Mr. W. P. Gould, C.A.

* * *

Messrs. William H. Richter, C. Usher and C. Vineberg, practising under the name of Richter, Usher & Co., Chartered Accountants, announce that as of May 1, 1950 their practice is continuing under the name of Richter, Usher & Vineberg, Chartered Accountants, with offices at 660 St. Catherine St. W., Montreal.

ONTARIO

Hamilton and District Chartered Accountants Association

The Hamilton and District Chartered Accountants Association met in the Royal Connaught Hotel on March 28 in order to hear an address by Mr. Clem King, F.C.A., secretary and research director of the D.A.C.A., on "Trends in financial statement presentation". Mr. King emphasized the desirability of a clear statement of the basis of valuation of inventories and referred to some complications which may arise from the somewhat restrictive wording of the new income tax regulations on this subject. Mr. C. K. McGillivray expressed to Mr. King the deep appreciation of the audience for his talk.

* * *

The Council of the Institute of Chartered Accountants of Ontario have announced that the following 28 members have been honoured by election to Fellowship in the Institute in recognition of their outstanding contributions to the advancement of the profession. Residence outside Toronto is indicated in brackets:

G. A. Adamson; D. A. Ampleford; W. J. Ayers; W. M. Brace; J. G. Brown, M.P.P. (Kitchener); J. R. Church (Vancouver); H. A. Cotnam; H. C. Dell; R. Dilworth; Prof. W. S. Ferguson; E. Fricker (Ottawa); K. E. Greenwood; M. Hilborn; W. I. Hetherington; W. F. Holding; E. A. Jarrett; C. L. King; Prof. W. G. Leonard (Kingston); G. M. Morrison (New York); W. T. Millard (Brantford); G. T. Miles; W. H. Moore; C. L. McConnell; J. D. McCormack; J. S. Reeves (Hamilton); J. W. Westervelt (London); D. F. Wilson; R. S. Watson (Hamilton).

The last election to Fellowship took place in 1947 and the present election brings the number of F.C.A.'s to 100.

THE PUBLIC ACCOUNTANCY ACT
1950 (Ont.), c. 60

AN ACT TO REGULATE THE PROFESSION OF PUBLIC ACCOUNTANCY IN ONTARIO

(2nd Session, 23rd Legislature, Ontario 14 George VI, 1950, assented to April 6, 1950)

HIS MAJESTY, by and with the advice and consent of the Legislative Assembly of the Province of Ontario, enacts as follows:

1. Interpretation.—In this Act,

(*a*) "Council" means The Public Accountants Council for the Province of Ontario established under this Act;

(*b*) "licensing date" means the 1st day of August, 1950;

(*c*) "prescribed" means prescribed by regulations made by the Council under this Act;

(*d*) "public accountancy" means the investigation or audit of accounting records or the preparation of or reporting on balance sheets, profit and loss accounts or other financial statements, but does not include bookkeeping or cost accounting or the installation of bookkeeping, business and cost systems;

(*e*) "public accountant" means a person who, alone or in partnership with others, carries on the practice of public accountancy and in connection with that practice offers his services for reward to members of the public, but does not include a person by reason of his practising public accountancy in respect of,

(i) any public authority or any commission, committee or emanation thereof, including a Crown company,

(ii) any bank, loan or trust company,

(iii) any transportation company incorporated by Act of the Parliament of Canada, or

(iv) any other publicly-owned or publicly-controlled public utility organization;

(*f*) "qualifying body" means The Institute of Chartered Accountants of Ontario or The Certified Public Accountants Association of Ontario.

2. Establishment of Council. — There is hereby established a Council, which shall be a body corporate under the name "The Public Accountants Council for the Province of Ontario" with power to acquire, hold and dispose of land.

3.(1) Constitution of the Council. — The Council shall consist of fifteen members as follows:

(*a*) eight to be appointed by The Institute of Chartered Accountants of Ontario;

(*b*) five to be appointed by The Certified Public Accountants Association of Ontario; and

(*c*) two to be elected in the prescribed manner by vote of the public accountants who are licensed under this Act and are not members of either qualifying body.

(2) Qualification of members. — No person shall be appointed or elected a member of the Council unless he holds a licence under this Act, but this prohibition shall not apply to the appointment of the first members of the Council.

(3) Elected members. — No person who is a member of either qualifying body shall be elected under clause *c* of subsection 1.

(4) First members under subsec. 1(c).— Notwithstanding clause *c* of subsection 1, the first two members to hold office under that clause shall be appointed, one by The International Accountants' and Executives' Corporation (Ontario) and one by the Ontario association of The Institute of Accredited Public Accountants, both such appointees to be public accountants practising in Ontario and not members of either qualifying body.

(5) Date of first appointments. — The first appointments shall be made on or before the 1st day of May, 1950.

4. (1) Certification of appointment.—The secretary of each body by whom a member or members of the Council is or are to be appointed shall certify in writing the name or names of the member or members so appointed.

(2) Certification of election. — The election of a member shall be certified in writing in the prescribed manner.

(3) Certificate as evidence. — Every such certificate shall for all purposes be sufficient evidence of the appointment or election of the member or members named therein.

5. Exercise of power of appointment.—The council or other governing authority of a body may exercise the power of appointment hereby conferred on that body.

6. (1) Term of office. — Every member of the Council shall hold office for a term of two years from the date of his appointment or election which, in the case of appointments made on or before the 1st day of May, 1950, shall be effective from that date and, in the case of all subsequent appointments or elections, shall be effective from the first ordinary meeting of the Council held in the term for which he was appointed or elected.

(2) Idem. — Every member shall hold office until his successor is appointed or elected.

(3) Re-appointment and re-election. — A retiring member of the Council shall be eligible for re-appointment or re-election.

(4) Vacancies. — Any vacancy in the office of a member of the Council shall be filled for the remainder of the term by the body which appointed him or by an election in the manner prescribed in clause *c* of subsection 1 of section 3, as the case requires.

(5) Effect of vacancy. — The Council may act nothwithstanding a vacancy in its number occurring from any cause.

7. (1) Resignation of member. — A member of the Council may at any time resign his office by giving notice to the Council.

(2) Removal of member. — The Council may of its own motion and shall, in the case of an appointed member if so requested by the body by which the member was appointed, remove a member from his office for any prescribed cause.

8. Functions of Council. — It shall be the duty of the Council to administer the provisions of this Act and in particular, but without limiting the generality of the foregoing, the functions of the Council shall include:

(*a*) the grant or refusal of licences, in accordance with this Act;

(*b*) the maintenance and, if thought fit, the publication of a roll of the persons for the time being licensed under this Act;

(*c*) the prescription of the fees payable on the grant or renewal of licences under this Act;

(*d*) the maintenance and improvement of the status and standards of professional qualifications of public accountants practising as such in Ontario;

(*e*) the consideration of matters of common interest and concern to public accountants, and the submission of representations to any government department or public authority with reference to any such matters;

(*f*) the provision of scholarships for students in public accountancy and of maintenance grants for such students whose means appear to the Council to be insufficient to enable them to pursue their studies;

(*g*) the conduct and encouragement, whether by means of financial assistance or otherwise, of research in accountancy;

(*h*) the exercise of the disciplinary powers conferred by this Act; and

(*i*) the prosecution of offences under this Act.

9. (1) First meeting of the Council. — As soon as practicable after the 1st day of May, 1950, the Council shall hold a meeting for electing a president, a vice-president, a secretary and such other officers as may be deemed necessary, who shall hold office until the first ordinary meeting of the Council held in 1951 and until their successors are elected, and, subject to the provisions of this Act, for determining upon procedure and upon all other matters required to be determined before the licensing date.

(2) Vacancy not to affect constitution.—For the purposes of such meeting the Coun-

cil shall be deemed to be duly constituted, notwithstanding any vacancy therein by reason of delay in the appointment of a person as a member thereof.

10. (1) Subsequent meetings of the Council. — The Council shall meet at such times and places as it may from time to time determine; provided that the Council shall hold at least one meeting in every period of three months to consider and determine applications for licences under this Act.

(2) Extraordinary meetings. — The president of the Council may at any time convene an extraordinary meeting of the Council at such time and place as he may, by notice to the members of the Council, direct, and the conditions as to giving such notice shall be as may be prescribed.

11. (1) Voting at meetings of the Council. — Except as otherwise expressly provided by this section, all matters which arise for decision at any meeting of the Council shall be decided by a majority of votes of members present and voting by show of hands.

(2) Assent required for certain resolutions. — No resolution of the Council relating to,

(*a*) any of the functions of the Council referred to in clause *b* or *i* of section 8;

(*b*) the making of regulations under section 33;

(*c*) the revocation or non-renewal of a licence granted under this Act; or

(*d*) the granting of an exemption to any person pursuant to subsection 2 of section 16 from any of the conditions of section 16, or the approval of conditions subject to which such exemption shall be granted,

shall be valid unless approved by the votes of at least three-quarters of the members of the Council present and voting thereon.

(3) Notice. — No resolution of the Council relating to any of the matters mentioned in subsection 2 shall be valid unless the notice calling the meeting at which the resolution is moved has specified the general nature of the business to be transacted thereat.

12. (1) Officers. — The officers to be elected from among the members of the Council shall be a president, a vice-president, a secretary and such other officers as the Council may deem necessary.

(2) Election of officers. — The election of officers shall take place annually at the first ordinary meeting of the Council in each calendar year when all officers then in office shall retire but if otherwise qualified shall be eligible for re-election; and in the event of a tie vote for the election of the president or vice-president, the issue shall be decided by lot.

(3) Term of office. — Subject to the provisions of this section and of subsection 1 of section 9, any officer elected by the Council shall continue in office for a term of one year and until his successor is elected.

(4) Vacancies. — Every vacancy occurring in any office by reason of the incumbent dying, resigning or otherwise ceasing to be a member of the Council during his term of office, shall be filled for the remainder of his term by the Council from among its members.

13. Quorum. — At all meetings of the Council eight members shall constitute a quorum.

14. (1) Committees. — The Council may from time to time appoint committees from among its members.

(2) Delegation to committees. — The Council may delegate to any such committee, subject to such restrictions or conditions as the Council may think fit, any of its powers or duties, other than those referred to in subsection 2 of section 11, and may dissolve any such committee.

15. (1) Roll of public accountants.—The Council shall before the licensing date prepare and thereafter maintain a roll to be called "The Roll of Public Accountants in Ontario".

(2) Entries on and erasures from roll.—The Council shall from time to time cause to be entered on the roll the name and address of every person licensed under this Act and shall cause to be removed therefrom,

(*a*) the name of every person licensed under this Act who has made application to the Council in the prescribed man-

ner requesting the Council to remove his name from the roll; and

(*b*) the name of every person whose licence under this Act has been revoked or has not been renewed in accordance with this Act,

and shall cause any other necessary alterations or corrections to be made therein.

16. (1) Qualifications for licence. — Any person shall, on application to the Council in the prescribed manner and upon payment of the prescribed fee, be entitled to be licensed under this Act if the Council is satisfied,

(*a*) that on the licensing date the applicant was a member of a qualifying body; or

(*b*) that on the licensing date the applicant was carrying on the practice of public accountancy and in that connection maintained in Ontario, either alone or in partnership with others, a place of business at which his services as a public accountant could be engaged, and was of good repute and had been in practice as a public accountant for one year before the licensing date; or

(*c*) that the applicant is a member of a qualifying body, having taken the regular courses and passed the final examinations of such body or of a body recognized by it for purposes of affiliation; or

(*d*) that the applicant has passed an examination deemed by the Council to be not less than equivalent to the intermediate examination of a qualifying body and has practised or been employed in public accountancy in Ontario for a period of not less than three years.

(2) Exemption from conditions. — The Council may, in special circumstances and subject to subsections 2 and 3 of section 11, either unconditionally or subject to such conditions as it may think fit, exempt any person from one or more of the conditions set forth in subsection 1.

(3) Licensees from other jurisdictions.— The Council may by regulation prescribe the terms and conditions upon which any licensee of a state or province other than Ontario may be exempted from one or more of the conditions set forth in subsection 1, but no such regulation shall be made, amended or repealed unless approved by the votes of at least two-thirds of the members of the Council present and voting thereon.

17. Period of licence. — Every licence granted or renewed under this Act shall become effective on and shall bear the date as of which it is granted or renewed and, unless revoked, shall remain in force until the date prescribed by the Council.

18. Renewal of licence. — Any person who is, and is entitled to be, licensed under this Act and who applies to the Council in the prescribed manner and pays the prescribed fee shall be entitled to have his licence renewed, but nothing in this section shall prejudice or affect the power of the Council to revoke any licence in accordance with this Act.

19. (1) Fees. — The fee payable for the grant or renewal of a licence shall not exceed $25.

(2) Recovery of fees. — The Council may sue for and recover any unpaid fees in any court of competent jurisdiction.

20. (1) Powers as to revocation of licence. — If a person licensed under this Act,

(*a*) has been convicted of a criminal offence;

(*b*) becomes of unsound mind;

(*c*) has been adjudged bankrupt or has made arrangement with his creditors; or

(*d*) has been found on inquiry held by the Council to be guilty of conduct disgraceful to him in his capacity as a public accountant,

the Council may, subject to the provisions of this section, revoke his licence.

(2) Notice of intention to revoke and hearing.—Where the Council intends to revoke any licence in pursuance of clause *a*, *b* or *c* of subsection 1, the Council shall first cause a written notice of its intention to be served on such person in the prescribed manner and shall on application made by such person within one month from the date of the service of the notice consider any representations with regard to the matter which

may be made by him to the Council, either in person or by counsel.

(3) Inquiry.—In any case in which it appears to the Council that a person licensed under this Act has been guilty of conduct disgraceful to him in his capacity as a public accountant, the Council may cause an inquiry to be held.

(4) Notice of inquiry.—Where an inquiry is to be held under this section, the Council shall forthwith cause to be served on the person concerned a written notice of the proposed inquiry specifying the time and place at which it is to be held and the subject matter thereof, and the person concerned shall on application be entitled to be heard at the inquiry either in person or by counsel.

21. Notice of refusal or revocation of licence.—Where the Council refuses the application of any person for the grant or renewal of a licence, or revokes any licence granted to any person it shall forthwith cause written notice of such refusal or revocation to be served on such person.

22. (1) Effect of revocation.—No person whose licence has been revoked shall, except as provided in this section, be granted a licence under this Act.

(2) New licence after revocation.—A person whose licence has been revoked may, either on his application or on motion of the Council and after inquiry, be granted a new licence and his name may be restored to the roll at the discretion of the Council either without payment of a fee or on payment of such fee as the Council may determine.

23. Appeal.—Where the Council,

(*a*) refuses to grant a licence or a new licence;

(*b*) refuses to renew a licence; or

(*c*) revokes a licence,

the person aggrieved may, within three months from the day on which notice thereof was served on him, apply to a judge of the Supreme Court who upon due cause shown may make an order directing the Council to grant the licence, renew the licence or cancel the revocation of the licence, as the case may be, or may make such other order as may be warranted by the facts, and the Council shall forthwith comply with such order and such order shall be final.

24. Obtaining licence by false representation.—If any person wilfully procures, or attempts to procure, the granting to him of a licence under this Act, or the renewal of such licence, by making or producing, or causing to be made or produced, any false or fraudulent representation or declaration, either orally or in writing, such person shall be guilty of an offence and on summary conviction shall be liable to a penalty of not less than $100 and not more than $250.

25. (1) Failure to surrender licence.—If any person ceases to be licensed under this Act, he shall, within fourteen days thereafter, transmit his licence to the Council for cancellation, and, if he fails to do so, he shall be guilty of an offence and on summary conviction shall be liable to a penalty of not less than $10 and not more than $25, and to a further penalty of not less than $3 and not more than $5 for every day on which the offence continues after conviction.

(2) Abuse of licence.—Any person who,

(*a*) uses a licence issued under this Act to another person; or

(*b*) allows a licence, issued to him under this Act, to be used by any other person; or

(*c*) not being licensed under this Act, uses or has in his possession any document purporting to be a licence issued to him under this Act,

shall be guilty of an offence and on summary conviction shall be liable to a penalty of not less than $50 and not more than $100 and, in the case of a continuing offence, to a further penalty of not less than $15 and not more than $25 for every day on which the offence continues after conviction.

26. (1) Restriction on use of title or carrying on business of public accountant.—On and after the licensing date and subject to the provisions of this section, no person who is not licensed under this Act shall, within Ontario,

(*a*) take or use the name or title of "Public Accountant";

(*b*) practise as a public accountant; or

(*c*) hold himself out as being licensed as

a public accountant or use any designation or initials indicating or implying that he is licensed as a public accountant.

(2) Permission for non-resident to practise.—Notwithstanding anything in this section, the Council may permit any person who is a non-resident of Ontario to practise as a public accountant within Ontario without a licence under this Act, subject to any terms and conditions that may from time to time be prescribed.

(3) Penalties.—Any person contravening the provisions of this section shall, without prejudice to any other proceedings which may be taken, be guilty of an offence and on summary conviction shall be liable to a penalty of not less than $100 and not more than $250 for a first offence and to a penalty of not less than $200 and not more than $500 for any subsequent offence.

(4) Defence.—Where a contravention of this section by any person is occasioned by the fact that his licence has been revoked, it shall be a good defence to any proceedings in respect of such contravention to prove that, at the time when such contravention is alleged to have been committed, notice of the revocation had not been served in accordance with this Act or the regulations hereunder, or that the time for appealing from the revocation had not expired or an appeal therefrom had been brought and had not been determined.

27. (1) Prohibition against a body corporate carrying on business as public accountant.—After the licensing date, it shall not be lawful for a body corporate to practise as a public accountant and any body corporate contravening the provisions of this subsection shall, without prejudice to any other proceedings which may be taken, be guilty of an offence and on summary conviction shall be liable to a penalty of not less than $100 and not more than $250 for a first offence and to a penalty of not less than $200 and not more than $500 for any subsequent offence.

(2) Liability of directors and officers.—If a corporate body is guilty of an offence under subsection 1, every director or officer of the body corporate who consented to, or connived at or was responsible for the commission of the offence, shall be deemed to be a party to and guilty of the offence and shall be liable to be proceeded against and fined accordingly.

28. No costs, etc., recoverable by unlicensed person.—After the licensing date no person shall be entitled to recover any costs incurred or charges made as a public accountant after that date unless such person was licensed under this Act at the time when such costs were incurred or when the services were rendered in respect of which such charges were made.

29. (1) Finances.—The Council shall establish a fund into which all moneys received by the Council shall be paid and out of which shall be paid all administrative and establishment expenses of the Council and all expenses incurred by the Council in carrying out its functions under this Act and all other liabilities properly incurred by the Council.

(2) Management of funds.—The Council shall manage, administer and keep proper accounts of the fund.

(3) Investment of moneys.—The Council may invest any moneys standing to the credit of the fund in any security in which trustees are authorized to invest.

(4) Borrowing powers.—The Council may from time to time borrow any moneys required for the purposes of the Council and may mortgage, hypothecate, charge or pledge any or all of its property and assets to secure the amount so borrowed.

30. (1) Payment of expenses, salaries and pensions.—The Council shall pay,

- (*a*) to the members of the Council such allowances for travelling and subsistence expenses incurred in the discharge of their functions; and
- (*b*) to the secretary and any other officers and employees of the Council such salaries and remuneration and on retirement or death, such pensions and gratuities,

as the Council may determine.

(2) Dependants of employees.—The Council may make provision for the dependants of any of its employees.

31. Audit of accounts.—The annual accounts of the Council and of its officers and

of any committee appointed by the Council shall be audited by a person licensed under this Act and appointed annually by the Council; provided that a member of the Council or a person who is in partnership with such a member shall not be eligible for appointment as auditor under this section.

32. (1) **Accounts to be furnished to qualifying bodies, etc.**—Within three months after the end of each financial year the Council shall forward a copy of the audited accounts of the Council for that year to each qualifying body and to the Provincial Secretary.

(2) **Copies.**—Any person licensed under this Act shall be entitled upon demand to receive a copy of the audited accounts.

33. (1) **Regulations, etc.**—Subject to the provisions of this Act, the Council shall or may, as the case may be, prescribe by regulation anything which is by this Act required or authorized to be prescribed and may make such further provisions as may seem to the Council necessary or desirable for carrying out or facilitating any of the purposes of this Act.

(2) **Copies.**—The Council shall on receipt of the prescribed charges supply a copy of any regulations made under this Act and of any forms prescribed by such regulations to any person applying therefor.

(3) **Annulment.** — The Lieutenant-Governor in Council may annul any regulation made by the Council under this Act.

34. **Authentication of regulations and other documents.**—Every regulation, licence, notice or other document made, granted or issued by the Council for any purpose whatsoever may be signed on behalf of the Council by the secretary or by such other officer of the Council as may from time to time be authorized by the Council so to do, and when so signed shall be *prima facie* evidence of such regulation, licence, notice or other document.

35. (1) **Service of documents.** — Any notice or document required to be given by or for the purposes of this Act may be sent by prepaid post and when so sent shall be deemed to be properly addressed if addressed to the person or body for whom intended at the last address of such person or body appearing in the roll or records of the Council, as the case may be.

(2) **Idem.** — Any notice relating to,

(*a*) the refusal to grant or renew a licence;

(*b*) the revocation of a licence; or

(*c*) the removal of the name of any person from the roll,

shall be sent by prepaid registered post.

36. **Saving.** — Nothing in this Act shall preclude a registered member of the Society of Industrial and Cost Accountants of Ontario, or any other person, from practising as an industrial accountant, a cost accountant or a cost consultant, and from designating himself as such.

37. **Freedom from action.** — No action shall be brought against the Council or any member or former member thereof that is based on the refusal of the Council to grant or renew a licence or that is based on the revocation by the Council of a licence.

38. **Commencement of Act.** — This Act shall come into force on the day it receives the Royal Assent.

39. **Short title.** — This Act may be cited as *The Public Accountancy Act, 1950.*

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

IF we read the history of accountancy aright, the businessman of long ago was much more likely to attribute the financial results of his enterprise to the hand of Providence than he is today. This is possibly because the businessman of, say, the fifteenth, sixteenth, and seventeenth centuries was more acutely aware of the element of risk in his venture than is his counterpart today. There were no insurance companies to assume any part of his anxiety for him, but on the other hand there were debtors' gaols to punish his insolvency. Trading by sea was especially risky because ships were not as seaworthy as now and were inclined to sink on slight provocation; further, a crude form of business enterprise known as piracy was a part of the competitive system. All in all there must have been little else to do but pray and hope for the best.

Referring in the year 1494 to the unfortunate possibility of debits exceeding credits in profit and loss account, Luca Paciolo wrote, "If the losses are in excess — from which state of affairs may God keep every one who really lives as a good Christian — then you add to the credit in the usual manner." (Paciolo means debit capital and credit profit and loss.)

But Paciolo realized that the balancing of the ledger, if not the result shown, was within the hand of man. "Now if these two grand totals are equal, then you shall conclude that your ledger was very well kept and closed. But if one of the grand totals is bigger than the other, that would indicate a mistake in your ledger, which mistake you will have to look for diligently with the industry and intelligence God gave you and with the help of what you have learned. Therefore take good care and make all efforts to be a good bookkeeper such as I have shown you fully in this sublime work to become one."

Of course, Luca Paciolo was a Franciscan monk. Still, even the lay bookkeeper of earlier times could reconcile the technicalities of a journal entry with a petition to Heaven. Here is a journal entry of the year 1595:

> Ready money is indebted to capital for my 8,000 guilders. And is for different coins of gold and silver that I have in hand to use in pursuing the trade of merchandise. God will grant me profit and preserve me from loss,
> Amen 000

We have taken the examples cited above from *Accounting Evolution to 1900* by A. C. Littleton.

* * *

We cannot resist adding another example, from a different source, which has come to our attention since first we assembled our material above. The following prayer, uttered by John Ward, M.P. in 1727, is on record:

> O Lord, Thou knowest that I have nine

houses in the city of London, and that I have lately purchased an estate in fee simple in Essex. I beseech Thee to preserve the two counties of Middlesex and Essex from fires and earthquakes. And, as I have also a mortgage in Hertfordshire, I beg Thee also to have an eye of compassion on that county, and for the rest of the counties Thou mayest deal with them as Thou art pleased. O Lord, enable the Banks to answer all their bills, and make all debtors good men. Give prosperous voyage and safe return to the Mermaid sloop because I have not insured it.

And because Thou hast said: "The days of the wicked are but short", I trust Thee that Thou will not forget Thy promise, as I have an estate in reversion on the death of the profligate young man, Sir J. L. . . . .

Keep my friends from sinking, preserve me from thieves and housebreakers, and make all my servants so honest and faithful that they may always attend to my interests, and never cheat me out of my property night or day.

(Quoted by Reginald L. Hine in *Confessions of an Un-Common Attorney.*)

* * *

We recall having read somewhere that the shareholders' meetings of the East India Company commenced with a word of prayer. This procedure, we submit, has been replaced by the current practice of concluding an all-too-brief annual meeting with a motion of gratitude to Management (instead of to the Almighty) "for the splendid operating results of the past year". It would seem that either we have learned to distinguish between material gain and divine pleasure or have become insufferably self-sufficient.

ANSWER TO LAST MONTH'S PUZZLE

At this point we wish to distinguish between an *answer* and a *solution*. The answer given by Yule and Kendall at the back of *An Introduction to the Theory of Statistics* is 10%. The solution presented below is our best attempt to date to arrive at this answer.

Suppose the maximum 30% who did not lose an eye are all included in the minimum 75% who lost an ear.*

Then at least 45% of the combatants must have lost both an eye and an ear.

But this 45% can, at the most, include 20% who did not lose an arm.

Then at least 25% of the combatants must have lost an eye, ear, and arm.

But this 25% can, at the most, include 15% who did not lose a leg.

Then at least 10% of the combatants must have lost an eye, ear, arm and leg.

* We are trying here to establish the minimum percent of combatants who have lost both an eye and an ear. The lowest estimate is obtained by assuming that *all* those who did not lose an eye are included among those who have lost an ear. In this way we reduce to a minimum the possibility of the loss of both an eye and ear coinciding.

PUZZLE

(a) Given that the following statements are true,

1. The Eskimos are the only people who eat nothing but meat, and
2. It is found that all Eskimos have good teeth,

is it a sound argument to conclude that *no people who eat nothing but meat have bad teeth?*

(b) Given that the following statements are true,

1. It is found that houses in which a dog is kept are *never* visited by burglars, and
2. It is also found that houses with telephones are *seldom* visited by burglars,

is it a sound argument to conclude that *some houses in which a dog is kept are fitted with telephones?*

(Adapted from *How to Think Straight* by R. H. Thouless, Simon and Schuster, New York, 1944)

CORRESPONDENCE

Toronto, Ont.

Sir: I read with interest the solutions presented for problems 1 and 2 in the March issue. In both the solutions the problem of the correct treatment of cash discounts is indirectly brought up.

The treatment suggested by the solutions of handling cash discounts not as financial revenue or expense but as an offset to the purchase or sale is exactly opposite to the treatment proposed and accepted in lessons.

Cash discounts are allowances made for the use of the debtor's money before it is due. As such they are quite different from trade discounts which are actual reductions in price and which are not affected by the promptness of payment.

In problem 1, the explanation given for allowing a cash discount received to be offset against a fixed asset is, "The credit of $166 for cash discount is a proper entry in the account because it is a reduction in the cost of the machine". I contend that it is not a reduction in the cost of the machine. It is revenue realized because the company had sufficient cash to pay its debt in advance of its due date. It is almost the same as if the company had earned interest on its money.

In problem 2, "more cash discounts being granted" is suggested as a reason for a decrease in gross profit. The only way cash discounts could affect gross profit would be if they were shown as a deduction from sales. If my contention that cash discounts are financial in nature is correct, then they must be shown after a net operating profit has been arrived at.

JOHN D. HARVEY

Editor's reply: While we do not have anything to do personally with the marking of the examinations, we think we can say that a student would not likely be penalized for treating cash discounts on merchandise purchases and/or sales in the conventional way as "financial items". The solutions published represent only the preferences of the particular accountants preparing them and do not in any way preclude the possibility of acceptable alternatives. On the other hand, we doubt if there are many accounting texts which would support the contention that cash discounts received on the purchase of fixed assets should be treated as financial revenue.

If we are not too presumptuous for saying so, we would like to draw attention to a most distinguished pronouncement on this very subject which appeared in the *Notes and Comments* of The Students' Department for June 1949.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1949

Accounting I, Question 7 (15 marks)

The surplus of the ABC Co. Ltd. as at 1 Jan 1948 was made up of the following:

Earned Surplus	$1,000,000
Capital Surplus	300,000
Distributable Surplus	60,000
Reserve for extension of plant	75,000
Reserve for bond redemption	120,000

The following transactions occurred during 1948:

(1) Cash dividends of $80,000 were declared and paid.

(2) Stock dividends of $50,000 were declared and paid in common shares from capital surplus.

(3) A machine originally costing $40,000 with a reserve for depreciation of $22,000 was sold for $25,000. It was known that the depreciation rate had been too high.

(4) Organization expense of $10,000 was written off to earned surplus.

(5) 50,000 no par value common shares were sold at $6.00 each and $1.50 per share was set aside as distributable surplus.

(6) The reserve for bond redemption was increased by $10,000.

(7) A reserve for contingencies based upon a threatened law-suit was set up for $30,000.

(8) The reserve for extension of plant was written off because of the construction of a new plant.

(9) Operating and non-operating profits for the year. $300,000 (excluding profit on disposal of fixed assets).

On 1 Feb 1949, after the books had been closed, the following errors were discovered applicable to the year 1948:

(i) Prepaid advertising had been understated by $5,000 on 31 Dec 1948.

(ii) Inventory had been overstated by $15,000 on 31 Dec 1948.

(iii) Interest expense accrued had been overstated by $500 on 31 Dec 1948.

(iv) Accrued wages had been overstated by $1,500 on 31 Dec 1948.

(v) Land costing $13,000, purchased as an investment on 1 May 1948, had been charged to expense.

(vi) A profit of $9,000 on the sale of a garage on 1 June 1948 had been credited to distributable surplus.

(vii) Depreciation on machinery had been overstated by $25,000.

(viii) Inventory of factory supplies had been understated by $300 on 31 Dec 1948.

Required:

Statement of the surplus accounts of the ABC Co. Ltd. for the year ended 31 Dec 1948 after giving effect to all of the foregoing items.

A SOLUTION
ABC CO. LTD.
STATEMENT OF SURPLUS ACCOUNTS
as at 31 Dec 1948

Unappropriated Surplus		
Balance at 31 Dec 1947		$1,000,000
Add: Net profit for year	$330,300	
Profit on sale of fixed assets	16,000	
Reversal of reserve for extension of plant no longer required	75,000	421,300
		$1,421,300
Less: Organization expenses written off	$ 10,000	
Appropriations for: bond redemption	10,000	
contingencies	30,000	
Dividends declared and paid	80,000	130,000
Balance at 31 Dec 1948		$1,291,300
Appropriated Surplus		
Bond redemption		$ 130,000
Contingencies		30,000
		$ 160,000
Capital Surplus		
Balance at 31 Dec 1947		$ 300,000
Less dividends declared and paid in common shares		50,000
Balance at 31 Dec 1948		$ 250,000
Distributable Surplus		
Balance at 31 Dec 1947		$ 60,000
Add amount set aside from sale of no par value common shares		75,000
Balance at 31 Dec 1948		$ 135,000

Editor's Note: The revised profit for 1948 is calculated as follows:

Balance per books at 31 Dec 1948		$ 300,000
Add errors decreasing profits		
Advertising	$ 5,000	
Interest	500	
Wages	1,500	
Land	13,000	
Depreciation	25,000	
Factory supplies	300	45,300
		$ 345,300
Less errors increasing profit:		
Inventory		15,000
Revised profit		$ 330,300

PROBLEM 2

Final Examination, October 1949

Accounting I, Question 3 (20 marks)

The management of the FGH Co., alarmed because of a steady and noticeable decrease in net profit, requests a chartered accountant to conduct an investigation to ascertain the reason for this decrease. The following information is given to him:

(i)

Year ending 31 Dec		1946		1947		1948
Sales		$940,000		$997,500		$1,155,000
Opening Inventory	$322,500		$ 357,500		$ 502,000	
Purchases	655,400		819,000		953,000	
	$977,900		$1,176,500		$1,455,000	
Closing inventory	357,500	620,400	502,000	674,500	585,000	870,000
Gross Profit		$319,600		$323,000		$ 285,000
Selling and Distributing Expense	105,000		117,000		124,000	
Bad Debts	2,000		1,900		3,100	
Management and other expenses	97,500	204,500	104,000	222,900	112,000	239,100
Net Profit		$115,100		$100,100		$ 45,900

(ii) The company deals in small hardware items, purchasing from wholesale houses, and selling at retail. There are two stores and a warehouse in the same city.

(iii) Although continuous inventory records of goods in the warehouse are kept, it has been many years since they have been balanced by actual comparison with physical count. The storemaster is convinced the continuous inventory records are correct, and says that to make the comparison it would be necessary to stop operations for a week. The management is reluctant to carry out a physical count.

(iv) Sales are made either for cash or on a 30 day credit basis and, in the opinion of the management, the selling prices in 1947 were 5% higher than in 1946 and in 1948 were 10% higher than in 1947.

Required:

On the basis of an analysis of the above information, outline the procedure the chartered accountant would adopt to carry out the investigation requested.

A SOLUTION

Analysis of Statements

	1946	1947	1948
Sales	$940,000	$997,500	$1,155,000
Sales price	1.00	1.05	1.155
Volume of sales on 1946 basis	940,000	950,000	1,000,000
Sales — Increased because of volume:			
10,000 @ 1.05		10,500	
50,000 @ 1.155			57,750
Sales — Increased because of price:			
940,000 @ .05		47,000	
950,000 @ .105			99,750
Total increase		$ 57,500	$ 157,500

Cost of sales	$620,400	$674,500	$ 870,000
Cost of sales — volume	940,000	950,000	1,000,000
Unit cost	.66	.71	.87
Increase because of volume:			
10,000 @ .71		7,100	
50,000 @ .87			43,500
Increase because of price:			
940,000 @ .05		47,000	
950,000 @ .16			152,000
Total increase		$ 54,100	$ 195,500
Expenses:			
As percentage of sales			
Selling and distributing	1.120%	1.170%	1.070%
Bad debts	.021	.002	.003
Management and other	1.030	1.040	.970
	2.171	2.212	2.043

Procedure to be adopted:

1. Examine purchase invoices to verify the increase in merchandise costs and to ascertain that all recorded purchases are actual purchases.
2. Enquire into the system and procedure in effect, particularly with respect to accounting for inventory. The flow of goods through the company from the ordering of merchandise from the wholesaler to final delivery to the customer should be traced and any slack procedures which might leave room for irregularities should be carefully noted.
3. Ascertain from the managerial head the reason why the increase in cost is not reflected in selling price. Possibly management has not been watching costs carefully in a rising market.
4. Are signed requisitions necessary before goods can be taken out? Are all goods requisitioned actually taken out?
5. Despite the storesmaster's assertion, it would be possible to make a physical count of a few inventory items. These might disclose errors in stores-keeping or overages of stock and account for the significant drop in gross profits.
6. Are all sales being recorded? The volume of sales does not seem to be increasing as greatly as the increases in expenses would indicate it should. Sales for the stores should be carefully checked against customers' orders and against delivery records to see that all goods sold are accounted for. Possibly, also, the increased sales effort is not bringing the expected return.

PROBLEM 3

Final Examination, October 1949

Accounting I, Question 4 (10 marks)

The Chiker E. Chic Co. Ltd. has reported a theft of $50,000 worth of finished goods under its burglary insurance policy. In support of its claim, it presents the following statement:

STATEMENT OF BURGLARY LOSS
as discovered 30 June 1949

Finished goods on hand 31 May 1949	$ 643,300
Add cost of goods completed during month per cost records	1,018,700
	$1,662,000
Less cost of goods sold during month	872,400
Finished goods which should be on hand	$ 789,600
Finished goods actually on hand 30th June when physical count made	739,600
Loss by burglary	$ 50,000

The adjusters have satisfied themselves that there was a burglary and that some loss was sustained.

The insurance company asks a chartered accountant to investigate this claim, and his first inquiries show that the figure for finished goods on hand as at 31 May 1949, is in accordance with the balance sheet signed by the company's auditor (who is also a chartered accountant) at that date, the end of the company's fiscal year.

Required:

What further investigation should the chartered accountant make to comply with the insurance company's request?

A SOLUTION

It would be the duty of the investigator to ascertain two things:

(a) the identity of the goods stolen, if possible.

(b) that the stolen goods were worth $50,000.

In order to do this, he should:

1. Check continuous inventory records with inventory sheets to identify items stolen.
2. Audit the cost records to verify the figure shown for cost of goods completed and transferred to finished goods. He should ascertain that:
   (a) Cost of raw materials is properly shown. This will involve test checking stores records, verifying that all purchases are proper, seeing that goods issued are properly recorded and reviewing inventory records and procedures to ascertain the validity of the inventory valuation and that this valuation is consistent with the opening inventory and may be reconciled with it.
   (b) Direct labour charged is correct and includes only wages properly chargeable to production.
   (c) Manufacturing expense included is charged on the usual basis and properly recorded, and that expenses include only those correctly chargeable to manufacturing.
   (d) Work in process has been correctly valued on the basis usually used by the company.
3. Test check the sales records for the month to ascertain:
   (a) All sales have been entered.
   (b) Goods sold have been delivered or if they remain in the company's possession, have been excluded from physical count of finished goods at 30th June.
4. Investigate routine of stores, particularly with reference to finished goods to ascertain that:
   (a) All finished goods are properly recorded.
   (b) There is little opportunity for employees to steal goods.

PROBLEM 4

Final Examination, October 1949

Accounting I, Question 5 (15 marks)

The Goyng Co. Ltd. wishes to issue 1st mortgage bonds and the directors have requested the auditor to sign the following statement:

"The profits available for the payment of bond interest have averaged $123,000 per annum for the years 1939 to 1948 inclusive."

The following schedule has been prepared from the annual financial statements of the company:

Year ended 31 Dec	Profits before Income Taxes and Depreciation	Taxes on Income	Dividends
1948	$ 110,000	$26,000	$40,000
1947	120,000	35,000	50,000
1946	110,000	32,000	20,000
1945	180,000	82,000	40,000
1944	150,000	61,000	50,000
1943	130,000	46,000	40,000
1942	120,000	32,000	40,000
1941	90,000	28,100	40,000
1940	100,000	24,600	50,000
1939	120,000	18,400	50,000
	$1,230,000		

The following analysis of the fixed assets account reflects the only entries made in this account, although in the determination of income for tax purposes, depreciation has been calculated at 10% per annum and the profit or loss on the disposal of fixed assets has been excluded, so that the figure for income taxes is correct.

FIXED ASSETS

1/1/1938—Cost of purchases	$164,000	1/1/1939—Realized from sales of fixed assets (a)	$ 3,800
1/1/1939— " " "	52,000	1/1/1941 " " " " " " (b)	12,600
1/1/1941— " " "	18,000	1/1/1943 " " " " " " (c)	25,000
1/1/1942— " " "	220,000	31/12/1948 Balance	412,600
	$454,000		$454,000

Note: (a) Assets cost $10,000 in 1938.
(b) " " 22,000 " 1939.
(c) " " 35,000 " 1938.

Required:

(a) The journal entries that would have been made each year in respect of depreciation and those that should have been made in respect of the disposal of fixed assets.

(b) The statement of earnings for inclusion in the prospectus which you would be willing to certify, and your certificate.

A SOLUTION

Date	Particulars			Dr.	Cr.
(a) 31/12/38.	Dr. Depreciation expense			$16,400	
	Cr. Allowance for depreciation				$16,400
	10% of $164,000				
31/12/39.	Dr. Allowance for depreciation			1,000	
	Loss on sale of fixed assets			5,200	
	Cr. fixed assets				6,200
	Adjustment for fixed assets sold				
	Cost	$10,000			
	Depreciation provided	1,000			
	Net book value	9,000			
	Sold for	3,800	and credited to fixed assets.		
	therefore, loss	$ 5,200	to be set up.		
	Dr. Depreciation expense			20,600	
	Cr. Allowance for depreciation				20,600
	10% of $206,000				
31/12/40.	Dr. Depreciation expense			20,600	
	Cr. Allowance for depreciation				20,600
	10% of $206,000				
31/12/41.	Dr. Allowance for depreciation			4,400	
	Loss on sale of fixed assets			5,000	
	Cr. Fixed assets				9,400
	Adjustment for fixed assets sold				
	Cost	$22,000			
	Depreciation provided	4,400			
	Net book value	$17,600			
	sold for	12,600	and credited to fixed assets.		
	therefore, loss	$ 5,000	to be set up.		
	Dr. Depreciation expense			20,200	
	Cr. Allowance for depreciation				20,200
	10% of $202,000				
31/12/42.	Dr. Depreciation expense			42,200	
	Cr. Allowance for depreciation				42,200
	10% of $422,000				
31/12/43.	Dr. Allowance for depreciation			17,500	
	Cr. Fixed assets				10,000
	Profit on sale of fixed assets				7,500

Adjustment for fixed assets sold		
Cost	$35,000	
Depreciation provided	17,500	
Net book value	$17,500	
Sold for	25,000	and credited to fixed assets.
Therefore, profit	$ 7,500	to be set up.

‡	Dr. Depreciation expense	38,700	
	Cr. Allowance for depreciation		38,700
	10% of $387,000		

‡ to be repeated for years 1944-1947 inclusive.

31/12/48.	Dr. Depreciation expense	26,800	
	Cr. Allowance for depreciation		26,800
	10% of $268,000		

(b)

Year ended 31 Dec	Profit before depreciation, taxes on income and dividends	Depreciation provided	Available for bond interest, income taxes and dividends	Income taxes excluding refundable portion excess profits tax	Net profits
1948	$110,000	$26,800	$83,200	$26,000	$57,200
1947	120,000	38,700	81,300	35,000	46,300
1946	110,000	38,700	71,300	32,000	39,300
1945	180,000	38,700	141,300	82,000	59,300
1944	150,000	38,700	111,300	61,000	50,300
1943 ‡	130,000	38,700	91,300	46,000	45,300
1942	120,000	42,200	77,800	32,000	45,800
1941 ‡	90,000	20,200	69,800	28,100	41,700
1940	100,000	20,600	79,400	24,600	54,800
1939 ‡	120,000	20,600	99,400	18,400	81,000

‡ The foregoing figures do not include a loss of $5,200 in 1939 on the disposal of certain fixed assets, a similar loss of $5,000 in 1941 and a gain on disposal of fixed assets of $7,500 in 1943.

I have examined the books and accounts of the Goyng Co. Ltd. for the ten years ended 31 Dec 1948, and in my opinion the above statement fairly presents the results of the operations of the company for the ten years ended on that date.

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Chartered Accountant